FULL COMMITTEE HEARING ON SARBANES-OXLEY SECTION 404: WILL THE SEC'S AND PCAOB'S NEW STANDARDS LOWER COMPLIANCE COSTS FOR SMALL COMPANIES?

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FULL COMITTEE HEARING ON SARBANES-OXLEY SECTION 404: WILL THE SEC'S AND PCAOB'S NEW STANDARDS LOWER COMPLIANCE COSTS FOR SMALL COMPANIES?

TUESDAY, JUNE 5, 2007

U.S. HOUSE OF REPRESENTATIVES,
COMMITTEE ON SMALL BUSINESS,
Washington, DC.

The Committee met, pursuant to call, at 2:10 p.m., in Room 2360 Rayburn House Office Building,Hon. Nydia M. Velázquez [Chairwoman of the Committee] presiding.

Present: Representatives Velázquez, Larsen, Clarke, Ellsworth, and Chabot.

OPENING STATEMENT OF CHAIRWOMAN VELÁZQUEZ

ChairwomanVELÁZQUEZ. I call this hearing to order.

This afternoon the Committee will examine implementation of Section 404 of the Sarbanes-Oxley Act and consider whether the new standards that the SEC and PCAOB approved last month will lower compliance costs for smaller companies.

Small firms continue to be supportive of the intent of the Sarbanes-Oxley Act and many have benefited from the stronger corporate government's culture that it encourages. What we continue to find is that many aspects of complying with SOX, and particularly those associated with Section 404, are disproportionately impacting small companies. These continue to make me believe that these new regulations should be delayed.

This additional time is especially important for smaller companies which often operate with limited human and financial resources and may be unreasonably burdened by these high costs. We may jeopardize some of our country's most innovative endeavors if we fail to adequately balance investor protection with the associated regulatory burden.

Last month new management guidance and an auditing standard for Section 404 were approved. The result of nearly 2 years of work, this new standard seeks to make Sarbanes-Oxley compliance more efficient and cost effective for companies of all sizes. While I am encouraged by this, I am concerned about the proposed timeline under which small firms will have to comply with the new regulations.

An important step to mitigating this will be, prior to the SEC's approval of the auditing standard, the Commission should undertake a full analysis as prescribed by Section 603 of the Regulatory Flexibility Act. This will ensure that this regulation is appropriately tailored.

Earlier this year Ranking Member Chabot and I wrote to Chairmen Cox and Olson and expressed our concern that the proposed implementation timeline was inadequate to assess its effectiveness. Postponing the December 2007 and December 2008 deadlines by at least 1 year would allow for the new standards to be tested and for evidence to be collected that could confirm that the new standards do, in fact, lower costs for small firms.

Small businesses are significant sources of research and development, job creation and innovation in our economy. It is critical that the SEC and PCAOB work to ensure that SOX 404 is implemented in a way that contributes to increased investor confidence, but that also does not hamper America's competitiveness. Postponing the compliance deadlines for at least an additional year would allow us to make this determination.

A delay will also provide training for small companies and auditing firms. It will also permit the PCAOB's efficiency inspectors to assess whether audit firms are implementing the new standards in the manner intended. At a minimum these steps will help ensure a more effective implementation of these new standards and recognize the unique situation that many companies find themselves in.

These new standards come at a time when small businesses are already spending 45 percent more than larger firms on regulatory compliance. To ensure that these burdens become more manageable we should not be piling new regulations on until they have been thoroughly reviewed. Today's hearing will help us accomplish this, and by doing so, it will demonstrate that a delay is necessary to better balance the cost and benefits of these new standards.

I would like to take this opportunity to welcome Chairman Cox and Chairman Olson and also to thank the members from the second panel that are traveling from across the country to be here to shed some insight regarding the implementation of Section 404 on small firms.

Now I recognize Mr. Chabot for his opening statement.

OPENING STATEMENT OF MR. CHABOT

Mr.CHABOT. Thank you, Madam Chairwoman, and thank you for holding this hearing on Section 404 of the Sarbanes-Oxley Act and its impact on small businesses.

The Sarbanes-Oxley Act has been described as the most important and far-reaching securities legislation since the Securities Act of 1933 and the Securities Exchange Act of 1934, which were passed following the stock market crash back in 1929. Signed into law in 2002 in response to the bankruptcy of Enron Corporation, the WorldCom scandal and other corporate failures, the Sarbanes-Oxley Act established the Public Company Accounting Oversight Board, a private-sector, nonprofit organization that oversees public company auditors and enacts auditing standards. The act also restricts accounting firms from performing a number of other services

for companies which they audit and requires new disclosures for public companies and officers and directors.

While the act has generally been viewed as necessary to restore public and investor confidence in our capital markets and improve the reliability and transparency of commercial financial reports, concerns have been raised about the burden and cost of compliance for small- and medium-sized companies.

One of the most controversial provisions, Section 404, management assessment of internal controls, requires management and auditors to assess internal controls over financial reporting and requires external auditors to report on management's assessment and certify to the effectiveness of internal controls.

The Securities and Exchange Commission greatly underestimated the amount that it would cost small businesses to comply with Section 404. According to an April 2006 Government Accountability Office study, small businesses expend a disproportionately greater amount of time and money as a percentage of revenues compliant with Sarbanes-Oxley than large public companies. Firms with $1 billion or more spend 13 cents per $100 in revenue for audit fees to comply with Sarbanes-Oxley regulations, while small businesses spend more than $1 per $100.

It is generally agreed that Sarbanes-Oxley has had a positive effect on investor protection and confidence, but its burden on small business has not only affected their bottom line, but also their competitiveness in our global academy.

GAO found that small businesses used resources for Sarbanes-Oxley compliance rather than for other business activities. Recently, the Kauffman-RAND Center for the Study of Small Business and Regulation said that Sarbanes-Oxley caused small firms to exit the public capital market. Last year the Securities and Exchange Commission announced that it would delay the application of Section 404 to the smallest companies until later in 2007.

Earlier this year the chairwoman and I together urged the SEC to delay implementation of the new internal control standards to allow small businesses additional time to comply. On May 23, 2007, this year, the SEC announced it would not allow such an extension. At its May 23, 2007, meeting the SEC adopted rules designed to reduce costs for compliance with Section 404 for all businesses. In addition, the Commission adopted proposed rules examining the general disclosure requirements for small companies wanting to go public. This represents an excellent opportunity for the Commission to examine the cumulative impact of its rules on small companies and reduce those while still striving to maintain investor confidence.

Madam Chairwoman, I commend you for holding this hearing on Section 404 compliance. I want to note that in addition to our panel of experts we have with us an attorney from Cincinnati, my district, who has real-world experience in helping small public company clients to deal with the challenges of Section 404 compliance.

I look forward to this hearing from each of our witnesses. We want to thank them in advance for their testimony.

And I also want to welcome to Washington, D.C., my brother, my younger brother, 10 years younger, Dave, and his wife Ellen who are with us today with their four beautiful children and they are

in the back there. How about the whole family stand up back there. Kids, come on and stand up. We don't have visitors up here all that often. There are a whole bunch of them there. So those are Chabots back there. And that's how we pronounce it, even though it gets pronounced all different ways up here.

ChairwomanVELÁZQUEZ. And welcome to my club.

Mr.CHABOT. Exactly. That's right. I yield back my time.

ChairwomanVELÁZQUEZ. Thank you.

Our first witness is our former colleague, the Honorable Christopher Cox. He is the 28th chairman of the Securities and Exchange Commission. He was appointed by President Bush on June 2, 2005, and unanimously confirmed by the Senate on July 29, 2005. During his tenure at the SEC Chairman Cox has brought groundbreaking cases against a variety of market abuses, including hedge fund insider trading, stock options back-dating and securities scams on the Internet.

Prior to joining the Securities and Exchange Commission, Chairman Cox served for 17 years in Congress where he held a number of positions of leadership in the U.S. House of Representatives.

Honorable Christopher Cox, you are welcome and we are very grateful that you are here with us today.

STATEMENT OF THE HONORABLE CHRISTOPHER COX, CHAIRMAN, SECURITIES AND EXCHANGE COMMISSION

Mr.COX. Madam Chairwoman, thank you very much for your gracious introduction to my colleagues. I am very, very honored with the opportunity to be here, along with Chairman Olson, to talk about this very important subject.

The Committee has a very important charge, and we share a good portion of what you are responsible for within our sphere at the Securities and Exchange Commission. We all have a responsibility to the millions of small businesses in America and, in that way, to our economy.

For our part, the SEC is charged by statute with the protection of investors, fostering efficient markets and the promotion of capital formation. Small business needs all of these in order to survive. So like every member of this Committee, the SEC is completely committed to fostering a climate of entrepreneurship. That climate is necessary to help promote small business growth, and it is necessary to the creation of the many jobs and goods and services in our country that are produced by small business,

Today, as every member of this Committee well knows, there are over 6,000 public companies that are smaller businesses that still aren't required to comply with Section 404 of the Sarbanes-Oxley Act of 2002. Generally that is every public company with securities registered with the Commission if it has less than $75 million in public equity.

The Commission has, as you have noted, delayed Section 404 compliance for smaller companies precisely because of the disproportionately high costs that they face compared to larger companies. Our experience in the first 3 years of compliance after the enactment of SOX told us that the way that 404 was being implemented was too expensive for everyone. And imposing that system

on the smallest companies would impose unacceptably high costs from the standpoint of the companies' investors who would have to pay the bills.

So the Commission and the Public Company Accounting Oversight Board set out to address the unique concerns of small business; and as you are aware, the Commission has carefully phased in application to the 404 requirements. We have repeatedly deferred 404 compliance for smaller companies with the very positive result of this determination to phase in 404 for smaller companies being that we and they have had and will have the opportunity to field test the requirements first.

Now we are using what we have learned thus far and we will continue to use what we learn to lessen the burden for smaller companies that eventually will have to comply with Section 404. We have little doubt that the SEC's new guidance, specifically for management, and the PCAOB's new standard, which Chairman Olson will talk about in a little more detail in a moment, will be of significant help to smaller companies when, beginning with their SEC annual filings in 2009, they eventually comply with the audit provisions of Section 404. In the meantime, for their filings in 2008, they will have to comply only with the management assessment portion of Section 404.

For this purpose, the SEC's new guidance should be especially helpful. It is written in plain English. It suggests that certifying officers at smaller companies ask themselves two basic questions: First, do my employees understand what they need to do to prepare reliable financial statements; and second, what information do I need to be sure that they have done those things.

The answers to these questions needn't be complicated or costly. And certainly our guidance won't make them so. In fact, the guidance clearly highlights the areas where cost-effective implementation has been a challenge for small companies in the past so that these pitfalls can be avoided, and it explains how a small company might approach 404 differently than a large company. None of this should be unduly difficult for most companies, and it certainly does not require the 404 audit that has had smaller companies so concerned about cost.

As we meet here in mid-2007, the requirement of an internal control audit under Section 404 won't apply to smaller public companies with calendar and fiscal years until their filings in the spring of 2009, almost 2 years from now. In the meantime, those smaller companies can begin to get ready for full SOX 404 compliance by undertaking their own assessments of internal controls beginning with their SEC reports in 2008.

So, in response to suggestions that the Commission should extend 404 compliance for another year, the answer is that smaller companies won't be required to come into full compliance with SOX 404 until their report is due in March 2009, almost 2 years from now. This schedule gives smaller companies the benefit of doing an initial internal assessment of their controls without the added burden and cost arising from an external audit. We fully expect that by the end of 2008 management's familiarity with the 404 process and its documentation of internal controls will make it easier and

less expensive to do an external audit than it would have been under the previous system.

Madam Chairwoman, the focus of this hearing is on whether the SEC's new guidance for management and the PCAOB's new standard for auditors will lower compliance costs for small companies. The answer to that question is ″yes.″ we expect the unduly high costs of implementing Section 404 of the act under the previous auditing standard will come down. They should come down because now a company will be able to focus on the areas that present the greatest risk of material misstatements in the financials. That is what the law has always intended we be focused on. It is always what investors care about; it is what is important for achieving reliable financial reporting.

Compliance costs should come down because the new SEC guidance that has been developed specifically for management will allow each small business to exercise significant judgment in designing an evaluation that is tailored to its individual circumstances. Unlike external auditors, management in a smaller company tend to work with its internal controls on a daily basis. They have a great deal of knowledge about how their firm operates. Our new guidance allows management to make use of that knowledge, which should lead to a much more efficient assessment process.

Compliance costs should also come down for the minority of smaller public companies that had already complied with Section 404 under the old auditing standard. In recognition of the fact that many of those companies have already invested considerable resources in the design and the implementation of their processes the Commission's guidance does not disrupt or require any changes to what they are now doing.

While these smaller companies should benefit from the top-down, risk-based, materially focused and scalable nature of both the SEC's new guidance and the PCAOB's new auditing standard, they should not have to expend new resources to do so.

The goal of our collective efforts in this area, the SEC and the PCAOB, is to implement Section 404 just as Congress intended in the most efficient and effective way to meet our objectives of investor protection, well functioning financial markets and healthy capital formation by companies of all sizes. We won't forget the failures that led to the passage of the Sarbanes-Oxley Act in the first place, and we won't forget that for small business to continue to prosper, both strong investor protection and healthy capital formation must go hand in hand.

These past few weeks have witnessed several positive steps for small business at the SEC. Not only are we approaching the finish line in our work to rationalize and improve the 404 process for smaller companies, but also we are tackling several other issues of importance to our Nation's small businesses. The most important of these is our effort to modernize and improve capital raising for small business and to simplify SEC reporting for small business. Many of these proposals would implement key recommendations made by the Commission's Advisory Committee on Smaller Public Companies.

Our concerns for small business go hand in hand with our responsibility to protect investors. It is, after all, investors who are injured and whose money is lost when the small businesses in which they invest can't get affordable access to new capital.

Madam Chairwoman, the SEC takes extremely seriously and equally seriously each element of its tripartite mission. The 404 reforms, the capital-raising improvements that I just mentioned and the reporting simplifications that we proposed to benefit small business will, I am certain, help our country to accomplish all three of these objectives.

Thank you again for the opportunity to speak on behalf of the Commission, and of course I will be happy to answer your questions.

ChairwomanVELÁZQUEZ. Thank you Chairman Cox.

[The prepared statement of Mr. Cox may be found on page 49 of the Appendix.]

ChairwomanVELÁZQUEZ. Our next witness is the Honorable Mark Olson, who became chairman of the Public Company Accounting Oversight Board on July 3, 2006. The PCAOB is a private-sector, nonprofit corporation created by the Sarbanes-Oxley Act of 2002 to oversee the auditors of public companies.

Prior to his appointment to the PCAOB board, Mr. Olson served as a member of the Federal Reserve Board of Governors and the Federal Open Market Committee. Before becoming a member of the Federal Reserve Board, Mr. Olson held a number of positions in the banking industry and was a partner with the accounting firm, Ernst & Young.

Welcome, sir.

STATEMENT OF MARK W OLSON, CHAIRMAN, PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD

Mr.OLSON. Thank you very much. Madam Chairwoman Velázquez and Ranking Member Chabot and members of the Committee, I am delighted to be here today on behalf of the PCAOB. I am pleased to be here with Chairman Cox, whom we have worked closely with in this effort. The full text of my statement has been submitted for the record, but I would like to make a couple of summary comments and then be happy to answer any additional questions that you might have.

I think at the outset it is important to remember—and I know that all the members of the Committee do, but just as a reminder—the 404 does not apply to all small businesses. Section 404 applies to small businesses that choose to access the U.S. capital markets; and that is a critical distinction, because in exchange for your willingness to access the U.S. capital markets, the management has been asked to accept a heightened level of responsibility for the internal controls over financial reporting.

That new responsibility, I think, helps provide stability to the U.S. capital markets, but very importantly, it helps build confidence in markets for the average investor. And that is critically important because, as all of the members know, I am sure, over half of U.S. households are now equity holders in one form or another. In my mind, it is the essence of Sarbanes-Oxley 404.

And I agree with Ranking Member Chabot when he says that is probably the most significant legislation since the 1933 and the 1934 Acts. But what it does is provide a level of confidence that wasn't there before. But it is the third time Congress has chosen to act and to act in a way that has mandated internal controls over financial reporting. The first was the Foreign Corrupt Practices Act and the second was in FDICIA.

That said, we are working in a number of ways to specifically focus on small business at the PCAOB in two particular ways that I would like to highlight: first of all, the fact that most of the registrants that registered with us, the accounting firms, the auditing firms that registered with us, are themselves small businesses.

I was surprised, when I looked closely at the statistics regarding the PCAOB, that there are 1,700 accounting firms, auditing firms, that have registered with the PCAOB, which means that there are 1,700 firms that either now do or wish to audit companies that are traded in the U.S. public markets. Of those 1,700, 1,000 them are in the U.S., and of those 1,000, only 150 have 5 or more publicly traded companies that they audit. So 800-some—850 roughly—firms that register with us either audit fewer than 5 or are not listed currently as the auditor of any, but they choose to. And that number is growing so that there is an increasing number of small firms around the country. There are 129, for example, in New York alone and 1934 in Ohio alone that fit this category.

Also we have been working very hard to make sure that as we get closer to the implementation for the small, nonaccelerated filers that the small firms can be ready; and let me give you a couple of examples of what we are doing.

First of all, we are hosting seminars around the country for the small accounting firms and, in some cases, members of audit committees. We have done those with 21 different firms in 14 different markets, that have been attended by over 2,000 people, where we have acquainted them with the PCAOB; but more importantly, helped them understand and recognize the extent to which the responsibility will be for auditing under Section 404, particularly for the nonaccelerated filers.

Point number two is that we are working with a group of 12 accounting firms now to specifically focus on developing guidance for the smaller firms, so that as they are getting ready to audit on 404, we can help them identify how they would identify the key controls and how they would identify a control environment that would be more applicable to a small firm, so that it can reach the point that you mentioned, Congresswoman, when you talked about the disproportionate burden that would fall to small business if we don't aggressively address that point. That is precisely the effort that is under way.

Point number three, Chairman Cox indicated, which we have just passed and sent to the SEC for their review, the AS 5, the scalability portion of that adjusted standard, specifically focuses on ways that we can be scalable to address the smaller and less complex businesses.

And I think, very importantly, as Chairman Cox mentioned, the fact that we are now linking the AS 5 with the management guidance that have been produced by the SEC will in fact answer the

question that you asked at the outset, which is, will the revisions bring costs down. And I agree with the chairman, there is no reason why those costs should not come down because of the fact that we have made the standard that much more scalable and that we have reduced the wording that would have resulted in unnecessary procedures being made by the external auditor.

As to the delay, the bill was passed, as I said, in 2002. It has now delayed full implementation until 2009. To delay it a year, until 2010, would mean that full implementation would have taken the equivalent of four terms in the House of Representatives. And I think, in our judgment as we have looked at the manner in which we have delayed, and particularly what the SEC has done in staging the dates of compliance, it seems to me that there is adequate time built into it now for the firms to be ready.

[The prepared statement of Mr. Olson may be found on page 56 of the Appendix.]

ChairwomanVELÁZQUEZ. Thank you, sir.

ChairwomanVELÁZQUEZ. Chairman Cox, I know that you will not be able to stay to hear the testimony of the second panel of witnesses this afternoon, so I want to pose to you the question that I expect will be central to the second panel of witnesses.

Will you support further postponing SOX 404 compliance dates for smaller public companies?

Mr.COX. Chairwoman, I think because this has been the subject of my formal testimony and also Chairman Olson's, that I should ask you with respect to the upcoming panel—by the way I want you to know that the SEC will be here in full force to listen to that testimony—

ChairwomanVELÁZQUEZ. I understand.

Mr.COX. —but to make sure that we are addressing ourselves to the same question, are you focused on the 404 audit?

ChairwomanVELÁZQUEZ. Yes.

Mr.COX. Because I think what we have taken pains to explain is that while there will be required compliance with 404(a)—404 is very short, it has part (a) and part (b), and 404(a) compliance will kick in for smaller companies in 2008 and 404(b) won't kick in until filings in 2009.

ChairwomanVELÁZQUEZ. And I will have a question for you in terms of those dates.

Mr.COX. Right.

And so is what you are asking, are we thinking about 2010?

ChairwomanVELÁZQUEZ. Well, Mr. Chairman, in reading the testimonies that will be presented here this afternoon and in the meetings that we have had with the sectors that will be impacted by this, it seems that small companies do not feel that because they will have until 2009 to comply with the PCAOB—that the problem is that in order to comply with the SEC in 2008, they will have to incur expenses that have to relate to 2009.

And I am going to ask you this question so that you can see why there is so much concern, not about the fact that you are coming here and saying, "But they will not have to comply with those guidelines until 2009," but in order to comply, for the 2008 reports that they have to present to SEC in 2008, they will have to incur

expenses that are supposed to be related to the reports that they have to submit to the PCAOB in 2009.

In your testimony—

Mr.COX. Madam Chairwoman—

ChairwomanVELÁZQUEZ. I am going to try to explain in this question.

In your testimony you highlight that a further delay in the compliance date is at this point unnecessary. Explaining this point, you emphasize that small companies will not have to come into full compliance until March 2009. This reasoning assumes, however, that management is willing to sign annual reports for fiscal years ending on or after December 15, 2007, without an outside auditor's review.

Because of reasonable concerns about potential liability associated with information included in such reports, I expect that the December 2007 deadline is likely to force a number of smaller public companies to implement both the SEC's and PCAOB's new standard during the second half of 2007.

Do you agree that this is a likely consequence of the SEC's existing SOX compliance timeline for smaller firms?

Mr.COX. No, Madam Chairwoman, but I think it is very useful to have that question asked publicly and answered publicly.

That is not at all the intention of what the SEC is doing, nor is it the intention of what the PCAOB is doing, I think fair to say, although I will let Chairman Olson comment for the PCAOB.

What we are seeking to do is completely the opposite, and that is to stage compliance for smaller companies. There is absolutely no question, given all of the evidence that we have received—and as you know, we have been very carefully consulting with small businesses across America in a variety of formal ways. All of the evidence that we have received suggests that the costs that are of particular concern in Section 404 compliance relate to the 404 audit. As a result, by letting management for the first time have guidance directly from the SEC on what it should do as a company—not relying on its auditors, but what it should do to assess its own internal controls—and to be sure that its style is scaled for smaller companies so that their approach needn't be the same as it is for a large company, we think that they will have a very different opportunity than they would have had if they had to comply with what I am going to call ″old 404″ and ″old AS 2.″ after they have a year's experience with that process and after they get to watch other larger companies work with the new standard, AS 5, then and only then would they be required to file, themselves, financial reports that include as part of the integrated audit a 404 audit.

ChairwomanVELÁZQUEZ. Mr. Olson, you don't see the concern coming from small companies regarding compliance with PCAOB's and expenses that they will have to incur in order to comply with SEC by the year 2008?

Mr.OLSON. Well, we do see the concern. I think a number of things have been done to alleviate—I think the concern and the linkage between the management guidance that the SEC has just come out with on their 404(a) and the new audit standard that we have done on 404(b) help address that issue.

I think it is very important because the management guidance was designed as guidance for management, obviously. And what that guidance does is to outline for the management of a company that is already very much aware of the internal control environment that they have. And for the companies that already have good internal controls, the management guidance will still be that important guidance; but for companies that have postponed taking a careful look at their internal control environment, this will tell them what management is to do.

And as you indicated, they will be required to file that a year from now. Then the external auditor, which is the standard that we have provided—the external auditor will then have until the following year to have completed the audit.

Part of what was not addressed—and I think that this is part of the concern—is that in the AS 2, the AS 2 guidelines which were very specific were sometimes taken as the de facto standard for management. What the SEC has done now is to give them a much more manageable guideline that I think will help address that concern.

ChairwomanVELÁZQUEZ. Well, let me ask you both, didn't you think that small companies will seek an outside audit opinion in order to sign off on the submissions, as requested by the SEC?

Mr.COX. Of course they will have audited financials.

ChairwomanVELÁZQUEZ. But you said that, no, the costs will be lower since they don't have to comply until 2009. But in order to comply with the report that they have to send to you, they will have to seek an outside auditor's opinion.

Mr.COX. But that audit, just to be clear, if we are talking about 2007 and 2008, that audit will not be a 404 audit of the company's internal controls, but rather it will be the financial audit that is necessary for all public companies and has always been necessary for smaller public companies.

ChairwomanVELÁZQUEZ. Let me ask you, in your testimony you confirm that the new standards will reduce SOX 404 compliance costs for small firms. In this afternoon's second panel, we will hear testimony from experts indicating that it is impossible to know whether compliance costs will go down until the new standards are implemented in a small business environment.

Can you share with the Committee how you know that the new standards will lower compliance costs for smaller companies and by how much you expect the compliance costs to decrease?

Mr.COX. Well, of course the benchmark for measuring any reduction that might be anticipated in compliance costs has to be what it costs today to comply. There are companies, including companies with a below-$75 million public float that have, for whatever reason, come into compliance early, and those companies provide a benchmark. There is absolutely no question that AS 5 is going to be more flexible for the reasons that I outlined, more top-down, more risk-based, more materiality focused and more scalable than it is predecessor, AS 2.

For all of those reasons compliance is going to be much less costly. The necessity for what I would consider to be redundant, unnecessary or immaterial work will be eliminated. The focus will be on what truly matters.

This is not to say that it will be a cost-free exercise. But what we are seeking to do is bring the costs more in alignment with the benefits. Since this is real work, it is intended to produce real benefits. The investors are paying; the investors deserve those benefits.

ChairwomanVELÁZQUEZ. But you come here, sir, and you testify to the fact that this is going to lower compliance costs, that they will go down. In 2003, the Security and Exchange Commission forecast that the average cost of SOX compliance will be $91,000; this forecast proved to be a significant underestimate of the actual compliance costs.

My understanding is that the SEC intends to release the new management guidance and auditing standard without a cost estimate. Can you tell us why this is?

Mr.COX. In fact, the cost-benefit analysis that the law requires, that the Regulatory Flexibility Act requires, will be included as part of our submission to the Office of Management and Budget, which I believe we are making today—if not today, it will be tomorrow.

And with respect to that 2003 analysis of what SOX compliance was expected then to cost, as you know, in 2003 I was a Member of the House of Representatives and a member of the Financial Services Committee; and like you, I voted for the legislation with the understanding that Section 404 would provide great benefits to the country and to investors and then would not be unduly burdensome or cause waste.

The evidence that we have all seen since then indicates that not only was that estimate wrong, but I think our estimation as legislators of what was going to happen in consequence of 404, modeled as it was on FDICIA, was also in error. And that is why I am so firmly convinced that this needs to be changed to bring it into alignment with congressional intent.

ChairwomanVELÁZQUEZ. Well, I am a member of the Financial Services Committee, and I do support the spirit of the law. And we all know the problems that we saw in terms of corporate America scandal. We understand that.

In my role as the Chair now and ranking when we passed the law, I consistently raised the issue about the impact that Section 404 would have on small companies. The fact of the matter is that we have the Regulatory Flexibility Act that requires for agencies to conduct a full economic analysis, impact analysis of the regulations. What we have seen and what we have read about the regulatory flexibility analysis that you have conducted, it looks to me to have been quite limited; and we are concerned about that.

So I would like to see if you have more data or information as to the regulatory flexibility analysis that you conducted to share with this Committee.

Mr.COX. Well, of course we will share with the Committee any analyses that we have that you think would be of interest to you. Beyond that, I think it is important to point out that because we are staging compliance for smaller companies differently from larger companies who will have to come into compliance in 2008, we will have the benefit of that year. And if the Commission learns that our estimations are in error, that what we intend to happen

is not what is happening, then we will have the opportunity to consider further postponement of compliance.

ChairwomanVELÁZQUEZ. I am glad to hear that.

And now I will recognize Ranking Member Chabot.

Mr.CHABOT. Thank you, Madam Chairwoman.

And, Chairman Cox, I will begin with you if I can. Would you review for us what educational efforts the Commission is undertaking for small businesses to make them more aware of the new Sarbanes-Oxley Section 404 compliance requirements?

Mr.COX. I would be pleased to do that.

We are right now in, essentially, the planning stages for that effort because we don't yet have a new standard that is in effect. And our management guidance, while it is, as I mentioned, going to be 404(b), the review will not be completely final for a short while. When that occurs and when we can go out and talk about our new management guidance and our new audit standard, we intend to have a special focus on communicating with small business, not only in the usual ways through speech making and our liaison with small business, but also through our Office of Investor Education and Assistance.

We hope to prepare brochures that will be specially designed for small business to accompany the management guidance, which already was written with small business in mind, meant to be flexible and so on. And I will do everything that I can in a small business friendly way to communicate in ways that small business can understand without hiring expert help.

Mr.CHABOT. Thank you.

Should the SEC be concerned that some small businesses are deciding to list their stocks on foreign exchanges in order to raise capital and avoid compliance with Sarbanes-Oxley Section 404?

Mr.COX. Yes. There is no question that when companies list in the United States that are stronger investor protections. And so to the extent that U.S. investors are going to end up owning any of these issues, we are all better off from an investor protection standpoint if that activity occurs in the United States.

So we are focused, as you might imagine, on ensuring that our regulations and our entire theme is focused on getting the maximum amount of investor protection with the maximum amount of activity in U.S. capital markets.

Mr.CHABOT. If the Commission prepared a final regulatory flexibility analysis, did it estimate the cost of compliance for small companies seeking to go public?

Mr.COX. While we do not have a dollar figure attached to that, it is, as I mentioned, because we will have the benefit of a year of real-world experience before that requirement kicks in.

Mr.CHABOT. I yield to the chairwoman.

ChairwomanVELÁZQUEZ. In order to comply with the Regulatory Flexibility Act, you have to do a full cost analysis, so where is the cost?

Mr.COX. We did in fact comply fully with the requirements of the Regulatory Flexibility Act, including Section 607.

ChairwomanVELÁZQUEZ. But then you have a cost. What will be the cost for small companies to comply?

Mr. COX. Well, all I can tell you beyond that, because I have been assured by both the Commission's counsel and the Division of Corporation Finance that this is the case, that the very same package that we are providing to OMB, I believe this day, we will be able to happy to provide in real time to the Committee.

Chairwoman VELÁZQUEZ. And will you commit with this Committee that if it doesn't have a full cost analysis, compliance will be delayed until such an analysis is conducted?

Mr. COX. Yes, of course; and compliance is already delayed. But I will absolutely assure this Committee both today and prospectively that we will be in full compliance with the Regulatory Flexibility Act.

Mr. CHABOT. Reclaiming my time, Mr. Olson, I will turn to you now if I can.

There is no doubt that the audit standard requires a fair amount of exercise of independent accounting judgment by auditors. What is the likelihood that the exercise of such judgment will increase the cost of audits?

Mr. OLSON. Congressman, there is an element of accounting judgment that goes into many accounting transactions, and—because even as precise as our accounting standards are, there still is a significant amount of judgment it involves.

The role of the PCAOB when we do the inspections is that we look at the manner in which the accounting has been audited. So—it is the audit component of it that we look at, and so what we do is, we look at the extent to which the auditing standards have been followed with respect to the accounting, and where we see accounting treatment that we think is questionable, it is at that point we refer that to the SEC.

But—it is the audit component that we look at, but one of the reasons, as I think you are pointing out—and it takes a great deal of skill to do this—is the fact that there is a lot of judgment required in many of the accounting treatments.

Mr. CHABOT. Thank you.

Will the board entertain recommendations from smaller companies and their auditors as they gain experience with the new audit standard in an effort to further reduce the cost of the audit standard?

Mr. OLSON. We meet continuously with the accounting profession, with the audit profession, in a number of venues; and our examination process is very dynamic, which is to say that we are changing it continuously as we learn more.

You may remember, as you know, that we are a 4-year-old organization; we have completed 3 full years of doing inspections, and it was an inspection methodology that we had to build from scratch. So we have been developing that continuously and we have been working to improve it continuously. As we have learned more and as the environment has changed, and more importantly, as the auditing profession has changed, we have changed our approach too.

So the answer to that is definitely "yes."

Mr. CHABOT. Thank you. I am pleased to hear that, and I would strongly encourage the board to take into consideration what the

small business folks and the auditors say as time goes on, as they become more familiar with it.

And so I am glad to hear that.

Madam Chair, I yield back the balance of my time.

ChairwomanVELÁZQUEZ. Ms. Clarke.

Ms.CLARKE. Thank you very much, Madam Chair, for holding this hearing today on this very critical issue. We must ensure that these new guidelines being discussed today provide small business the relief they so desperately need.

I would like to also just sort of highlight, Madam Chair, your focus on the unintended consequences of this timeline that is set forth to implement AS 5 and the management guidelines. The roll-out is where we really need to focus right now, and I think that has been some of what you have been hearing from the Committee.

Chairman Cox, I wanted to ask that while the SEC approved new management guidelines on May 23 to help navigate the burdensome provision of the Sarbanes-Oxley Act, your administration said it was not necessary to give smaller companies additional time to comply with Section 404. But now it appears, based on your testimony here today, that you are willing to reconsider your decision.

Can you explain to us, why the sudden change in your position?

Mr.COX. Well, I don't believe that I have been articulating different positions. I am merely trying to make it clear that there are different timelines in place.

The management guidance that we are talking about is a separate piece from AS 5, which the PCAOB is talking about. That is going to go into effect a year later for smaller companies, so we already have a built-in delay until 2008 for management guidance and 2009 for AS 5, the PCAOB's audit standard.

And then, in response to the Chairwoman's question about what would happen if we learned as a result of the built-in year of experiential base that we will have looking at AS 5 being utilized by our companies, if that doesn't turn out as we intend, would we then consider further extension, the answer to that is absolutely ″yes.″

And that has been our view consistently. We expressed that at our recent public meeting. I think all the Commissioners are of that view. It is expressed in the formal written testimony that we provided though this Committee.

And by the way, because we are a five-member commission and that written testimony presented, it has been voted upon and approved by all five commissioners. So I think I speak very much for all members of the Commission that is our view.

Ms.CLARKE. And let me ask, you told Congress that your administration would not require smaller public companies to have a Section 404 audit until the new guideline and the new auditing standard were available.

Now that you are reconsidering delaying the rules, what standards will you examine to develop effective guidelines for small businesses? Has that been identified?

Mr.COX. Well, in fact the very guidance that we are talking about hasn't yet gone into effect. No smaller companies yet had the benefit of it, and we don't have any empirical basis to know whether it is achieving its intended result. But very soon we will. And we have done our level best at the SEC, and I assure you at the

PCAOB, that people have been working very, very hard on this with small business uppermost in mind, to make sure that this, unlike what preceded it, which in the case of the SEC was absolutely nothing—there was no guidance for management and people had to rely for the guidance on auditors—and in the case of the PCAOB was AS 2, that this will be much better and different.

And so we will soon benefit from all of that from companies that have already had to comply with SOX 404. And as I said, I strongly believe this is going to result in lower costs for them. That is the intent. It should.

And then a year later, when smaller public companies come on line, they should have the benefit of all of that experience and knowledge, and we should be very highly confident at that point that this is going to work as intended.

Ms. CLARKE. Well, I would like to suggest, Mr. Cox, that you make sure that this Committee is briefed as you go along through this process; and that the triggers that are in place to alert your agency as to whether there is going to be an undue burden, that you closely monitor that.

I think that SOX 404 is critical. It is very important to the investors and to the public trust. However, we don't want to sink businesses in the process that are not at a capacity to be able to absorb these new regulations in a way in which it will be meaningful for their entry into the public arena in providing us with the goods and services that we require as a nation. So I hope that you will really monitor that very closely.

Thank you very much, Madam Chair.

Chairwoman VELÁZQUEZ. Mr. Larsen.

Mr. LARSEN. Thank you, Madam Chair.

Just a few questions, Chairman Cox. Glad to have you before the Committee. I am sure you are enjoying it as much as we are.

A quick question; this is certainly related to Mr. Chabot's question about investor protection versus the listing in foreign exchange markets. Are you seeing, assuming it has a relationship to what we are dealing with, but maybe not direct, maybe indirect—are you seeing a difference between new listings being more predominantly focused on foreign exchange markets versus a migration of existing public companies? Rather than choosing to enlist here for their initial public offering, choosing somewhere else versus existing public companies seeking to raise dollars elsewhere or list separately overseas, is there a difference at all in that which you are seeing as a result of SOX?

Mr. COX. Well, the focus has been on IPOs. And of course it is much easier to make that election up front. But particularly with respect to smaller companies we have not seen a great deal.

There is no question that the vast majority of offerings occur in the United States and not oversees, albeit if one takes a look at the percentage changes in overseas markets, such as AIM, you will see the trend is up.

Mr. LARSEN. With regards to the management guidance and AS 5, I just want to get this straight.

What exists to ensure that the 404 guidance and AS 5 won't migrate to companies above the line? That is, we want to ensure that small businesses can comply so we are giving them some extra

time. Can we be assured that—obviously we want SOX to be implemented for the reasons we saw a couple of years back; can we be assured that no one else is going to come and try to raise that line of who has to comply?

That is, it is going to be focused on small businesses for the delay, and as we see this thing test out, can we be assured that higher cap companies aren't going to return and say, well, we want in on this too, we want to be delayed too? Because we are seeing problems with some of these smaller companies and we experience the same delays, can we be assured that the SEC is going to stay focused on moving forward with SOX compliance?

We are really only talking about helping out the small business side on this.

Mr.COX. In fact we were talking about helping out all companies, but as you point out, in a very different way.

With smaller companies it has been through deferral while we craft a better, more suitable standard that they could comply with in a scalable way. With larger companies they are already in compliance with 404; they have had to comply. And so what we are doing for them is changing what had been an overly complicated and overly expensive and cumbersome standard to one that is more flexible and more focused on the true material risk about which investors care the most.

And so, in that way, I think that the new standard will benefit companies of all sizes. But there is no reason to think that we are going to take companies that are already in compliance and tell them they can come out of compliance.

Mr.LARSEN. Thank you, Madam Chair.

ChairwomanVELÁZQUEZ. Mr. Ellsworth.

Mr.ELLSWORTH. Madam Chairwoman, I don't have any questions for this panel.

ChairwomanVELÁZQUEZ. I do have more questions. Mr. Olson, the Advisory Committee on Smaller Public Companies to the Securities and Exchange Commission and the biotechnology, electronics, semiconductor, telecommunications and venture capital industries have all recommended that the new standards should include a revenue filter. As I understand it, the new standards employ neither a gross revenue number nor an indicator, like product revenue.

Why did the SEC and PCAOB opt not to follow the recommendations of the advisory committee?

Mr.OLSON. That is a very good question. We looked at the extent to which we could make the standard scalable particularly for small business, and as you may recall, in the standard that we have produced in December the whole portion on scalability was focused on small business.

And as we looked at that carefully the debate that went on was whether or not—what were the thresholds or what were the metrics that would determine whether or not a firm should be in one category or another. And what we carefully wanted to avoid was having what we would call buckets, that we would pull this amount of revenue or this amount of revenue and then have that apply to everybody in that category.

What we wanted to do instead was to have a standard that was idiosyncratic; that is to say, that could focus on the size and complexity of that individual company. And the manner in which the standard is now written, it is part of the auditor's responsibility to define at the outset the extent to which size and complexity impact the manner in which they have scoped the audit.

So I think that in fact we have addressed it in a way that will be more applicable to the specific needs and the specific size and complexity of the entity itself. For example, I know that there are some very small banks, not very many of them, but there are some very small banks that have very complex balance sheets, and they will take one sort of internal controls. There are also some very large companies that are relatively not complex and the control structure that they would put in place ought to reflect that.

With particular respect to the technology industry what you tend to get is some very well-capitalized companies that have very low revenue. I think for that reason they are saying we in fact should be put in a category with some smaller firms.

In effect, we have done that by the manner in which we have redone the scalability section by removing the small business focus and making it applicable to entities of all size.

ChairwomanVELÁZQUEZ. Chairman Cox, would you like to comment on that?

Mr.COX. Just technically, the SEC has not yet voted on AS5. We will have an opportunity after exposure to public comment to do so. So far we have been able to collaborate with the PCAOB on drafting it, and I am certainly very familiar with the discussion that you just had.

ChairwomanVELÁZQUEZ. Mr. Olson, since the new standards are principle-based and provide flexibility for auditors to employ their professional judgment, the standards will create significantly lower compliance costs only if they are implemented properly. This means that the PCAOB's efficiency inspectors have a very important role to play if the new standards are to result in lower SOX 404 compliance cost.

So my question is how many efficiency inspectors doesPCAOB have on staff and what month would the PCAOB begin inspecting audited firms' implementation of the new standards?

Mr.OLSON. First of all, you are exactly right. In terms of the implementation, it is my sense that we have the words right in the new standard and the key to it being more cost effective is the implementation.

With our inspections of auditing firms, the inspections include right now that we look at the efficiency and the effectiveness on the audit of internal controls over financial reporting only for those companies at this point, of course, that are the accelerated filers. The same people do both. And there are about 250 that we have in the field right now who are doing those inspections.

ChairwomanVELÁZQUEZ. Two hundred fifty.

Mr.OLSON. Two hundred fifty. When we get to the point—and, remember, it is the expectation that as the audits are done that these will be integrated audits, so the audit of internal controls and the financial audit will be done in an integrated fashion. So it is

important as we look—as we go out and do the inspections that we are looking at both simultaneously.

We would like to have in the area of 300 or so inspectors. We think at that level we will have a full complement. That is not exactly a fungible commodity out there, people with audit experience, so we are having trouble finding enough good people.

ChairwomanVELÁZQUEZ. Chairman Cox, both the PCAOB and SEC have used the term "right size" to describe what the recent revisions will do to audits. What is meant by this term and what do you envision a success?

Mr.COX. This is related to the discussion that the Chairman and Madam Chairwoman just had about complexity. Companies come in all different shapes and sizes. The check-the-box mentality was thought to be the Achilles heel of AS2. AS5 takes a completely different approach. Our guidance for management takes this same principle-based approach and also permits reliance on judgment, reliance on the work of others. It permits focus on materiality, on things that truly matter to the financial statements.

By focusing on the control environment of a particular company and making sure that what management understands it is tasked to do is to assess its internal control system, not to design an internal control system that is reverse-engineered for the audit, it is going to make a big change.

ChairwomanVELÁZQUEZ. What do you envision a success? How would you measure it?

Mr.COX. In two ways. We hope to get higher-quality financial statements because we are focusing on the jugular and no longer focused on the capillary. We are also hoping to reduce the cost of compliance. This is not alchemy.

ChairwomanVELÁZQUEZ. But you don't have the cost yet, the cost of compliance, do you have it?

Mr.COX. We certainly have current costs and we will very quickly have empirical evidence about costs under the new standard and the new guidance.

ChairwomanVELÁZQUEZ. I am sorry; what was your answer about the fact that you don't have a cost for compliance?

Mr.COX. It is our estimate that costs will be significantly lower for the reasons that we described. The precision of our estimate is going to be in the putting, if you will—that is to say, since companies are already in compliance with a standard that we believe is more difficult than what we are replacing it with, there is no one who has worked on this that doesn't believe that costs ought to come down. This is the purpose of the exercise.

ChairwomanVELÁZQUEZ. If it doesn't come down?

Mr.COX. Then of course we will revisit it immediately.

ChairwomanVELÁZQUEZ. What would be the time line for that?

Mr.COX. With respect to smaller companies, which I know you are focused on intently in this Committee, the point of having an opportunity to look at this for a year first is so that we will have the benefit of that experiential base.

ChairwomanVELÁZQUEZ. Okay. Any other member has a question? Mr. Chabot.

Mr.CHABOT. Thank you, Madam Chair. In the interest of getting to the next panel I will just have one final question here, and either or both of the witnesses could answer if they want to.

Do you believe that the audit standard places the proper emphasis on fraud risk, or should the standard be further amended to impose a greater focus by the auditors on fraud risk? Either one or both are welcome.

Mr.OLSON. Congressman, one of the significant revisions that we made in the final draft was to move up within the standard itself the focus on fraud risk, because we think that is very important and we wanted to make sure that the standard highlighted the procedures that they ought to be taking in order to attest for fraud risk exposure.

So I think with respect to the audit component of it, have given it appropriate priority in the standard.

ChairwomanVELÁZQUEZ. I have a last question for Chairman Cox. Next month when the SEC receives public comments on AS5, e small business community will be able to comment on the proposed new auditing standard. So what input will be most likely to encourage you to support a further extension of the SOX 404 compliance for small companies?

Mr.COX. I think that input would have to be in parallel with comments on AS5 because AS5 doesn't contain the schedule. I honestly don't want to tell the small business community what they should be telling us. I think our point is we need to listen, we need to be attentive to what they have to say. But we will be. I think—

ChairwomanVELÁZQUEZ. And you will be listening.

Mr.COX. The important thing is that we are taking this very, very seriously because we know, not only for companies that are already public but for companies that have no publicly traded shares and no IPO plan, their ability to raise capital near term is in some measure a function of investors' sense that someday they will be able to tap the public markets. So for companies of all sizes, not just those on the verge of an IPO, this is really important, and we understand that.

ChairwomanVELÁZQUEZ. Any other member?

Mr.CHABOT. Madam Chair, one final question. Sorry. Mr. Cox is now obviously the head of the Securities and Exchange Commission, but before—as you mentioned—that, he had a distinguished career here in the House of Representatives. I'm curious: Is it more fun to be up here asking the questions or answering them? You don't have to answer that but you are welcome to.

Mr.LARSEN. I am sure it is a great pleasure for him to be here answering our questions.

Mr.COX. Well, you gave me the option of not answering. I will say being invited to a congressional hearing and offered the opportunity to not answer questions is truly enjoyable.

Mr.CHABOT. Thank you. I yield back.

ChairwomanVELÁZQUEZ. No other member has any comment or question. Then the first panel is excused and I want to thank both Chairmen Cox and Olson for their time, and I welcome you back. I especially remind you, once again, the answers that we are expecting regarding the Regulatory Flexibility Act, full cost analysis, it is important for us too.

With that, I excuse the first panel.

I will ask the second panel of witnesses to take their seats and the hearing will resume shortly.

[Recess.]

ChairwomanVELÁZQUEZ. We are going to resume our hearing. I want to welcome you all and thank you for your patience.

So our first witness is the Honorable James C. Greenwood. He is President and CEO of the Biotechnology Industry Organization in Washington, D.C., which represents more than 1,100 biotechnology companies. Prior to that he represented Pennsylvania's Eighth District in the U.S. House of Representatives from January 1993 through January 2005. While serving in Congress Mr. Greenwood was a leader on health care issues, authoring numerous bills signed into law, including legislation to promote pediatric labeling for pharmaceuticals and reform medical device review and approval. You are welcome. It is good to see you back here in the House of Representatives. You will have 5 minutes to make your presentation.

STATEMENT OF JAMES C. GREENWOOD, PRESIDENT AND CEO, BIOTECHNOLOGY INDUSTRY ORGANIZATION (BIO)

Mr.GREENWOOD. Thank you very much. Chairwoman Velázquez, Ranking Member Chabot, and other members, I thank you for providing the opportunity for us to testify before you today on reforms to the Sarbanes-Oxley section 404 adopted by the Securities and Exchange Commission and the Public Company Accounting Oversight Board.

I am Jim Greenwood, President and CEO of the Biotechnology Industry Organization. I am privileged to be here today on behalf of BIO, an organization, as the Chairwoman said, of more than 1,100 biotechnology companies, academic institutions, and other organizations in all 50 U.S. States and 31 nations.

The promise of biotechnology is immense, as our members combine in biology and technology to deliver new treatments for unmet medical needs, improved crops that are more drought-resistant and have reduced environmental impact and create cheaper, more environmentally friendly fuels and consumer products. Biotech is one of the most innovative, high-growth sectors of our Nation's economy and one in which the United States maintains global leadership.

First, I would like to start by providing a short answer to the Committee's question posed in the title of this hearing as to whether or not we believe the SECs and PSAOB's new standards will lower compliance costs for small companies. In summary, it is a marginal "yes." as this Committee well knows, it has been the implementation of section 404 that has gone awry.

The situation that many emerging biotech companies face is that funds that would be otherwise spent for core research and development of new therapies for patients are instead having to be used for overly complex controls or unnecessary evaluation of controls. As a conferee for this legislation in 2002, I know it was not intended to be a windfall for auditors nor pile on the compliance costs for small companies.

The scale of the problems that section 404 has created suggest that Congress should closely monitor the implementation of these

revisions to ensure that its original intent is achieved. It is critical to ensure that these new rules provide the greatest possible flexibility and scalability for small public companies.

For most biotech companies, the actual cost of section 404 compliance, including both internal cost as well as external auditor costs, are substantial. In fact, the opportunity costs of section 404 for smaller companies can be even greater, impeding the ability to invest in and, in some cases, to continue critical research and development activities for treatments of an array of diseases from cancer to multiple sclerosis.

The current problem with section 404 are not merely growing pains. Current implementation of section 404 imposes the same requirements, steps and reviews by the same individuals year after year. The Commission and the PCAOB have taken steps to address the problems that have manifested in the implementation of section 404. Both agencies suggest that these new requirements are to be scaled, risk-based, and flexible. While the SEC's final guidance is not yet public, we hope that it will provide a more flexible principles-based set of rules for management. On the other hand, the new standards adopted by the PCAOB could still be improved to enhance flexibility and auditor judgment.

Furthermore, one could fairly say that in its revisions to its initial December 2006 draft, the PCAOB has actually taken a step backward.

Included in both the Commission's and the PCAOB's draft proposals were objective measures auditors could use in determining what is a smaller company, mainly one with a market capitalization of less than $700 million and reported annual revenues of $250 million or less. This was consistent with the recommendation of the Advisory Committee of Small Public Companies. Who suggested that an objective test, particularly a revenue filter, be used as a tool to define a smaller public company than scaling the audit. Unfortunately, this definition of the small company has been removed from the final PCAOB-adopted rule.

Rather than maintaining the proposed objective definition of a smaller company and then expanding it to include the subjective criteria that could also be applied to parts of larger companies, an approach which BIO supports, the PCAOB removed the objective criteria altogether, and that is our largest complaint. By eliminating any reference to market capitalization or annual revenues, the PCAOB has taken away the only objective criteria for scalability included in the rule. In doing so, PCAOB appears to have moved from the presumption that a company meeting those thresholds is a small company that should be subjected to a scaled, less burdensome audit, to a presumption that every enterprise should be subject to the fullest, most comprehensive audit, unless the auditor determines otherwise using the subjective criteria in the rule.

As a result of this change BIO believes that the new standards may do less than the PCAOB's initial December 2006 revisions to counterbalance the incentives for auditors to be overzealous in their work. Consequently, while we were hoping for greater relief, it is now clear that PCAOB rules will lead to substantially lower audit fees or reduced burden on emerging biotech companies.

BIO has consistently advocated for scalability indicia that are most reflective of complexity, and we still believe that both the SEC and the PCAOB should recognize product revenue as an important indicator of complexity.

In addition, BIO member companies have raised concerns that after changing auditors they experience new interpretations of material weakness. Even within the context of a principles-based approach to auditing, some further clarification on this guidance is needed. BIO believes that clarification in the PCAOB-adopted rule should accomplish this.

Lastly, we strongly believe that a rigorous economic study of the costs and benefits associated with the implementation of section 404 is imperative to understanding if the current reform proposals are meeting the objectives, and I believe that the SEC analysis is qualitative and not quantitative, in answer to the Chairwoman's questions. We urge the SEC to provide an additional exception for non-accelerated filers. The Commission has the ability to make the much needed changes that we have mentioned.

In conclusion, BIO appreciates the efforts that both agencies have taken to improve SARBOX implementation. It is unclear, though, whether these reforms will fully match the rhetoric surrounding their adoption. However, we remain hopeful that this is just the first of several steps that both the PCAOB and the SEC will take in reducing the unnecessary burdens of Sarbanes-Oxley on America's emerging and innovative companies.

I thank you for your time and your consideration of BIO's views and I would be happy to answer any questions.

ChairwomanVELÁZQUEZ. Thank you.

[The prepared statement of Mr. Greenwood may be found on page 75 of the Appendix.]

ChairwomanVELÁZQUEZ. Our next witness is Diane Casey-Landry. She is President and CEO of America's Community Bankers, a national trade association committed to strengthening the competitive position of community banks. Prior to joining ACB in 2000, Ms. Casey-Landry served as Principal and National Director of Financial Services for Brand Thorton LLP. Her past experience also includes serving as Executive Director of the Independent Community Bankers of America, and as a bank examiner for the Federal Reserve Bank of Cleveland.

Welcome, and you have 5 minutes.

STATEMENT OF DIANE CASEY-LANDRY, PRESIDENT AND CEO, AMERICA'S COMMUNITY BANKERS (ACB)

Ms.CASEY-LANDRY. Thank you, Madam Chairwoman Velázquez and Ranking Member Chabot and members of the Committee.

I am Diane Casey-Landry, President and CEO of America's Community Bankers. Thank you for holding this very important hearing today and for the invitation to appear today to present to you our views on section 404 of the Sarbanes-Oxley Act and the recent changes on the management guidance and auditing standards made by the SEC and the PCAOP.

America's Community Bankers is the national trade association for the Nation's community banks of all charter types and sizes.

Our members represent $1.7 trillion in assets, they are located across this country and they are both stock, public and private, as well as mutually owned institutions.

Sarbanes-Oxley was a well-intentioned law, and ACB has also supported strong internal controls under the banking laws and regulations. No other publicly traded company is subject to the same scrutiny as a publicly traded bank. Because banks have been governed by numerous internal control reporting and assessment requirements long before Sarbanes-Oxley became law, this creates both unnecessary and duplicative burdens on the banking system.

The FDIC Improvement Act of 1991 dictates bank management's responsibility for financial statements and internal control assessments and attestations. This law actually served as the model for section 404. However, the implementation of 404 has been much more costly and burdensome.

As a meaningful reduction of this burden, ACB is supporting H.R. 1508, which has been introduced by Representatives Greg Meeks and Tom Feeney, which would create an exception from Sarbanes-Oxley section 404 based on a company's size. We are also supporting, similarly, the provision in H.R. 1869 which would relieve community banks with up to $1 billion in assets from the costly internal controls attestation reports of Sarbanes-Oxley, a similar change which was made by the FDIC 2 years ago for the FDICIA banks and which ACB had requested.

We applaud the efforts of both the Commission as well as the PCAOB to improve the implementation and reduce the compliance costs of section 404 through this principles-based approach. We are, however, very disappointed that the SEC decided against a further extension of the compliance states for non-accelerated filers despite several requests for such a delay, including one from this Committee. Accelerated filers have had 3 years of experience with the implementation process and they are the best able to incorporate changes brought about by the SEC and the PCAOB's recent action.

Community banks that are non-accelerated filers are very much concerned about the cost and burdens of compliance. Non-accelerated filers are the very companies that can least afford to add personnel, consultants and systems to comply with section 404. This is particularly true if the Commission's new management guidance and the PCAOB's revised auditing standards prove unsuccessful in reducing the costs and other burdens associated with implementing section 404 as a result of the actions by the accounting firms who have to implement these changes.

With the filing deadline just 6 months away, we remain hopeful that additional consideration for a reasonable 1-year extension be given on this important issue. We are also calling upon the Commission to update the Exchange Act threshold for registration OF a public company from the 500 shareholder level that was first imposed in 1964. Changes in market composition and participation illustrate a need for the threshold to be moved to a much higher range in order to provide overdue regulatory relief for smaller companies that choose to be public but choose not to be listed on an exchange.

Much has been said about the impact section 404 has on our capital markets and on our Nation's ability to compete, and the situa-

tion is really very grim from the standpoint of small companies. Section 404 compliance costs have caused many companies to either remain private or to consider going private because the costs associated with being a public company outweigh the benefits. For community banks, mergers and acquisitions are frequently motivated by regulatory burden and they often cite section 404 of Sarbanes-Oxley.

For example, as of today, the America's Community Bankers NASDAQ index is comprised of 517 banking companies. It has a market capitalization of $193 billion. Every year since the index inception in 2003, approximately 50 companies have left the index primarily because of mergers, but also because of delistings. ACB has estimated that as many as 20 percent of the departures each year from the index are because of a decision to delist, triggered primarily by efforts to reduce burdens created by Sarbanes-Oxley. And when community banks disappear, local communities lose.

Notwithstanding the importance of internal controls, there must always be balance with the costs and burdens imposed on smaller public companies, and part of achieving this goal is to reduce the amount of unnecessary regulatory burden hampering the ability of small companies and small community banks to compete domestically.

I very much appreciate the opportunity to appear before you today and for your continued work on this important issue and I would be pleased to answer any questions you will have. Thank you very much.

ChairwomanVELÁZQUEZ. Thank you very much.

[The prepared statement of Ms. Casey-Landry may be found on page 84 of the Appendix.]

ChairwomanVELÁZQUEZ. Our next witness, Mr. Hal Scott. He is the Nomura Professor of the Program on International Financial Systems at Harvard Law School. He teaches courses on international finance and securities regulation. Professor Scott is the director of the Committee on Capital Markets Regulation and past Governor of the American Stock Exchange. Before joining the Harvard faculty, Professor Scott clerked for Justice Byron White. Welcome, sir.

STATEMENT OF HAL SCOTT, NOMURA PROFESSOR, DIRECTOR OF THE PROGRAM ON INTERNATIONAL FINANCIAL SYSTEMS, HARVARD LAW SCHOOL

Mr.SCOTT. Thank you, Madam Chairwoman, Ranking Member Cabot, and members of the Committee. Thank you for giving me the opportunity to testify on this important issue on behalf of the Committee on Capital Markets Regulation which I will refer to, just to make it clear that it is our committee versus your Committee, as the CCMR.

I would ask that my full written statement be incorporated into the hearing record.

The CCMR is independent and bipartisan, composed of 23 corporate and financial leaders drawn from the investor community, business, finance, law, accounting and academia. CCMR issued its interim report on the state of the U.S. public equity capital mar-

kets on November 30th 2006. The CCMR's purpose is to explore a range of issues related to maintaining and improving the competitiveness of U.S. capital markets.

In my remarks today I would like to make three central points:

First, the debate over section 404 is a debate about the health and future of small business as much as anything else, because the costs of compliance, as you well know, fall hardest on those entities least able to afford them. This issue is about Main Street, not Wall Street, and it is important that you are focused on that.

Second, you are right to press on the questions of costs of compliance. As I will explain in a moment, neither we nor the SEC or PCAOB know the answer to your question, and that is a big problem if we are regulating in the dark on something so central to the U.S. company.

Third, there is an action that the SEC can take that would be helpful here. It should again delay applying both its rules and the PCAOB's rules to small business so we can develop a stronger factual record on the question of cost.

There is no denying that the costs of section 404 have been significant. According to the Financial Executives International, on a per-company basis SOX implementation costs are 4.4 million in the first year, 3.8 million in the second year, and 2.9 million in the third current year.

Despite the trend downward, 78 percent of the 200 executives surveyed by FEI said the cost of SOX section 404 still outweigh the benefits.

Recent actions by the SEC and PCAOB are a mixed bag. On the positive side, certain important improvements have been made that were called for by our committee. We strongly support a top-down, risk-based approach that allows auditors and management to make use of their judgment in tailoring their evaluations of controls to the individual circumstances of companies they audit, so-called scalability.

We support eliminating the requirement for an auditor to examine management's evaluation process. We support the increased flexibility provided for auditors to rely upon the work of others and to limit the testing of low-risk controls. Finally, we also commend the PCAOB's focus on fraud controls.

While we are supportive of these actions, we remain very concerned about something that the agencies should have done but have not. They have failed to provide a quantitative standard for material, as applicable to both section 404 and financial statement audits. Our committee recommended that materiality for scoping an assessment should be defined as it was traditionally, in terms of a 5 percent pretax income threshold. This standard will be consistent with the overall risk-based approach advocated by both the SEC and the PCAOB. In cases where the 5 percent test would not be meaningful, the agency should allow companies and their auditors to exercise their reasoned judgment.

We are very concerned that without a presumptive quantitative standard, the costs of compliance with section 404 will not be sufficiently reduced.

Our committee also recommended the completion of a thorough cost-benefit analysis before the revised standards were applied to

small companies. This the agencies have not done. Instead they intend to apply the new standards to all companies, big and small, at the same time: 2008, the management standards; and 2009 for the auditing standards.

To our way of thinking it is a real problem that no real cost-benefit analysis has been done for any companies, at least as part of the proposal. This appears inconsistent with the requirements of Sarbanes-Oxley and Administrative Procedures Act, as explained in more detail in my written testimony, as well as sound public policy.

With all due respect, it is not sufficient for the SEC to release a cost-benefit analysis with apparently no empirical evidence after adopting its rule. If the agencies were to begin by only applying the standards to companies over $75 million in capitalization savings, they could field test for the cost of the standards—I know I am running over my time, I will wrap up shortly. They could field test for the cost of the standards to the smallest of these large companies, for example, those between 75 to 100 million in market capitalization. This could give us a good idea what the cost would be for even smaller companies.

Bear in mind that for small companies that have been not yet required to apply section 404, a key issue is how much the new standards will bring down first-year costs. Historically, $4.4 million.

Our committee found that a substantial portion of the 404 costs, as high as 75 percent, were due to the management's implementation of 404. Thus, these costs are not avoided by only deferring to the PCAOB auditing rule. The SEC's management rule goes into effect this year for 2008 statements.

In our view, if the SEC determines the benefits justify the cost after field testing, the results of this determination, both for management and for auditor implementation, should be made public as part of a rulemaking procedure so that we all have a chance to see what the data is and to comment on it. Everyone— companies, Congress and the public—is entitled to know and comment on what the cost reductions would be.

By the way, Madam Chairwoman, one further thought. You made the point, and I think quite insightfully, that it raises a significant problem to implement the management part of the 404 before we implement the auditing part, because this puts the management of these small companies in a position of having to certify with high liability without the comfort of an auditor review. I don't think this is a tenable situation for the management of small companies to be in. Thank you very much.

ChairwomanVELÁZQUEZ. Thank you, Professor Scott.

[The prepared statement of Mr. Scott may be found on page 93 of the Appendix.]

ChairwomanVELÁZQUEZ. Our next witness is Mr. Mark Heesen. He serves as President of the National Venture Capital Association. Since joining NVCA in 1991 he has worked on behalf of NVCA's 480 member companies to demonstrate the positive impact of venture capital investment on the United States economy. Prior to coming to the NVCA Mark was an aide to a former Governor of Pennsylvania. Who was that?

Mr. HEESEN. Dick Thornburg, many, many years ago.
Chairwoman VELÁZQUEZ. Welcome.

STATEMENT OF MARK G. HEESEN, PRESIDENT, NATIONAL VENTURE CAPITAL ASSOCIATION (NVCA)

Mr. HEESEN. Thank you very much. Good afternoon.

Venture-backed companies accounted for 10.5 million U.S. jobs and $2.5 trillion in revenues in 2006. Venture-backed companies such as Google, Genentech, Starbucks, FedEx, Intel and Microsoft were all once small and privately held, waiting for the opportunity to go public. Today the next Microsoft is waiting, but has yet to go public because of burdensome SOX compliance.

In 2006 there were only 57 venture-backed IPOs on U.S. exchanges but there were also 17 venture-backed IPOs on foreign exchanges, something unheard of before Sarbanes-Oxley. What is even more concerning is that what we are now seeing is that companies that are viable U.S. IPO candidates are deciding to be acquired instead of going public, mainly in an effort to rid themselves of the SOX burden.

Imagine if Google had been acquired by Microsoft or if Genentech had been acquired by J&J. Perhaps the innovation would have survived, but the market value, the jobs, the revenues all would have been diluted substantially.

We commend the SEC for its recognition of the SOX problem, yet we do not believe that the combined SEC and PCAOB guidance goes far enough to effect the necessary changes to relieve the SOX burden for our smaller companies. We believe that three drivers are critical in this regard:

First, we are gravely concerned that the accounting profession will not change its high-cost practices and the guidance provided by both the SEC and the PCAOB regarding materiality is not specific enough to compel them to do so.

Second, the algopathy that exists for 404 audits leaves no choice for small companies in terms of service providers.

Lastly, because of these first two concerns it is imperative that prior to adoption all proposed measures are fully field tested to confirm that they indeed will reduce costs.

One area of guidance that we have had significant concern about is the determination of what is material to sound financial reporting. The original SOX language set the probability threshold extremely low. Any area in which there was, quote, more than a remote likelihood, unquote, for an error to result in a material mistake on the financials was required to be examined, documented and reported to the company's audit company. This language comprised just about everything.

Proposals put forth by both the SEC and PCAOB suggest changing this language to, quote, reasonable possibility, unquote. This general statement does nothing to distinguish itself from the original language, leaves everything open to interpretation, and will do little to reduce costs.

Although we support the move to enact principles-based guidance, we feel there should be an objective threshold if we are going to properly balance risk and cost. Since SOX was enacted, the relationship between the Big Four accounting firms and venture-

backed companies has become increasingly problematic. Many of our small companies have lost the attention of their Big Four auditors, who are favoring larger public companies that offer lucrative 404 auditing engagements. Those who do maintain their Big Four relationships do so at a 404 cost that averages close to a million dollars annually.

As Sarbanes-Oxley allows only for accredited accounting firms to complete 404 audits, our companies are basically held hostage to this oligopoly. We would not have these concerns if we had any comfort level that the Big Four accounting firms support SOX reform, but the profession has publicly warned the supporters of reform that, quote, they shouldn't expect a dramatic reduction in costs, unquote, with the adoption of these proposals. Anecdotally, our members are already being told by their auditors don't expect much, if any, savings in audit fees from the proposals as they are presently written.

While one would believe that private companies can bypass the Big Four and engage a second-tier accounting firm, this is frankly not a viable option. Investment banks that take these companies public or sell them require a Big Four audit as a sign of a clean bill of health. There is no competition.

The SEC should allow and Congress should support the ability of accredited accounting professionals beyond the Big Four to perform 404 attestations. By doing so we will create a healthy, competitive ecosystem where the market will set the right place for services rendered.

Despite an urgent need for reform we will ask today that the SEC move forward cautiously while formalizing the proposed guidance. Blindly adopting recommendations without field testing them first would be akin to a venture capitalist purchasing a company without doing due diligence. Field testing ensures that, one, the recommendations will indeed reduce costs; two, all the players, including the accounting profession, are operating in the spirit of reform; and three, that there are no unintended consequences.

Field testing will also allow the SEC to make the adjustments as necessary without having to reopen a new process. Let's prove that reform works before declaring victory.

In conclusion, we are really at a critical inflection point. The good work of all involved will be for naught if the accounting profession does not get on board with cost reduction or if implementation of these proposals fail. Taking the time to field test and placing the needed pressure on the Big Four to join the effort is required. We have waited way too long for this reform to take place, but we are willing to wait longer to make sure reform is right.

Thank you very much.

ChairwomanVELÁZQUEZ. Thank you, Mr. Heesen.

[The prepared statement of Mr. Heesen may be found on page 99 of the Appendix.]

ChairwomanVELÁZQUEZ. Our next witness is Mr. David Hirschmann. He is the Senior Vice President of the U.S. Chamber of Commerce and President of the U.S. Chamber Center for Capital Markets Competitiveness. Mr. Hirschmann is a member of the U.S. Chamber's management committee and in this position helps shape

the strategic direction of the world's largest business federation, representing more than 3 million businesses. Prior to joining the U.S. Chamber in 1992, Mr. Hirschmann worked as a legislative director for former Congressman Toby Roth. You are welcome.

STATEMENT OF DAVID HIRSCHMANN, PRESIDENT, U.S. CHAMBER CENTER FOR CAPITAL MARKETS COMPETITIVENESS, U.S. CHAMBER OF COMMERCE

Mr.HIRSCHMANN. Thank you, Chairwoman Velázquez, for having me here today, Ranking Member Chabot, and members of the Committee. I want to join the fellow panelists on this Committee in commending you for holding the hearing and I would like to make really four points:

First, we welcome the changes that the SEC and the PCAOB have made to try to reflect in their rules what Congress intended. We view the PCAOB's new auditing standard as well as the SEC's guidance for management as significant steps forward.

We do think Chairman Cox and the Commission and Chairman Olson and the Board should be commended for the leadership effort they are putting in and we believe they are trying to get it right. However, we will only know these efforts have been successful after we see how they are implemented by the auditors and companies and enforced by the PCAOB.

Third, until we have a full year of experience, we agree with others who have called for a delay in implementing the new rules. We believe it would be a mistake to make small businesses the guinea pigs for the application of these new rules.

It is important to remember that these rules are in place for fiscal years that are currently running. In other words, they are going to apply to activities that have happened in companies already for 5 months; and management and the accounting staff, which is very limited in small companies, are having to prepare already for an activity, even though they won't file the reports the next year, it is for things that are currently happening. So in a way, small businesses are already having to comply with rules that have not even been published. This is profoundly unfair and sets up a train wreck because, at the end of the day, the SEC won't know why it failed, if it does fail, and we hope it doesn't. They won't know if it was because the calendar they put in place was unworkable or the new rules themselves have not achieved the job. We think this is an avoidable train wreck that can be handled by a further delay.

Fourth, we urge Congress and the SEC to work together to address the additional critical issues that are making it harder and harder for leaders of smaller public companies to access the capital markets in order to grow their businesses and create jobs. The Chamber strongly supported many of the reforms in Sarbanes-Oxley, including more active and independent boards and board committees. Effective internal controls are an essential part of good financial governance for all companies. However, the implementation of section 404 has led to costs and compliance burdens which are far beyond what Congress intended and well in excess of any benefits that can be accrued to shareholders and management. This is amplified among smaller public companies to the economies of scale.

Companies feel they are getting less effective advice from their auditors, and auditors are increasingly being second-guessed by their new regulator and the trial bar. The result is predictable. Companies increasingly find the cost of being a public company outweigh the benefits.

For well over a century this has been the greatest country on Earth for entrepreneurs and innovators to access low-cost capital to start and expand a business. Transparent and liquid markets have been a key part of this.

The flawed implementation of Sarbanes-Oxley section 404 has a disproportionate impact on the cost of capital for small businesses that have already had to comply. For example, a $1- to $2 million compliance price tag is an enormous burden for companies that have $3 million in net income. Literally, we have heard from companies that are forced to choose between providing health care to their employees, buying new equipment, investing in R&D, or complying with section 404. That is an impossible choice to put a growing company through.

As Chairman Cox has noted, Congress never intended for the 404 process to become inflexible, burdensome and wasteful. The Chamber has consistently called for a series of changes to fix Sarbanes-Oxley 404, clarifying the terms such as material weakness, significant deficiency and materiality, ensuring that the rules are both risk-based and scalable, allowing for greater use of the work of others, providing specific guidance for IT systems and controls. We believe the SEC and PCAOB have tried to address each of these areas and others; however, we remain concerned about the extent to which the new standards will improve on-the-ground implementation.

We also understand that SOX 404 has become somewhat of a catch-all term to refer to a broader set of issues facing public markets and smaller public companies in particular. U.S. companies are facing changing retroactively applied accounting rules that are ever-increasing in complexity. As a result one in ten public companies is forced to restate their earnings last year. This system is not working for companies, for investors and for auditors.

America's securities class action litigation system is broken. It provides an inadequate compensation to injured parties without deterring future wrongdoers. It fails to protect small, undiversified investors who seldom receive more than pennies on the dollar, while attorneys on both sides rake in millions of dollars in fees. The system is not working, and security regulators struggle to keep up with the speed of technology changes in today's rapidly changing markets. The system is not working and our Nation is losing a key competitive advantage much.

The challenge is clear and the voices are growing. We need to work together to ensure that U.S. capital markets remain the fairest, most efficient, transparent and attractive in the world.

Chairman Velázquez, Ranking Member Chabot, I thank you for the opportunity to discuss these issues and for paying such serious attention to such important issues as capital formation in our country.

ChairwomanVELÁZQUEZ. Thank you, Mr. Hirschmann.

[The prepared statement of Mr. Hirschmann may be found on page 104 of the Appendix.]

ChairwomanVELÁZQUEZ. Now I recognize Ranking Member Chabot for the purpose of introducing his constituent.

Mr.CHABOT. Thank you very much. I have the distinct honor to recognize our next witness who is actually from my congressional district in the city of Cincinnati. It is Richard G. Schmalzl who is with Graydon Head & Ritchey, which is one of the top law firms in our area. He got his law degree, J.D., from the University of Virginia School of Law and LLM from Georgetown University Law Center. He is a partner with the firm, as I mentioned, of Graydon Head & Ritchey which is in Cincinnati, Ohio. Mr. Schmalzl serves as co-chair of the firm's Business and Financial Client Service Department. His law practice has an emphasis on securities law, mergers and acquisitions, private equity, venture capital, corporate governance. Mr. Schmalzl's recent publications include an article entitled ″Sarbanes-Oxley: Coming Soon To Your Family Business.″ we welcome you here this afternoon, Mr. Schmalzl.

STATEMENT OF RICHARD SCHMALZL, PARTNER, GRAYDON HEAD & RITCHEY LLP, CINCINNATI, OHIO

Mr.SCHMALZL. Good afternoon, Madam Chairwoman Velázquez, Ranking Member Chabot and members of the Committee. Thank you for inviting me to testify on the new 404 standards.

My name is Dick Schmalzl and I have practiced securities laws for 25 years, primarily in Cincinnati, Ohio. I work closely with large and small public companies in a variety of industries. In recent years I have been on the front line with CEOs, CFOs and boards of directors in helping them become Sarbanes-Oxley compliant. I hope the Committee will find my real-world experiences helpful to your consideration.

The views I share with the Committee today are my own views and should not be attributed to my law firm, Graydon Head & Ritchey, or to any client of my law firm.

I will address three primary topics: One, the most significant problems that 404 has caused for public companies, particularly small public companies; whether the new standards are likely to effectively address those problems; and thirdly, to urge the Committee to continue to evaluate the bigger picture of whether 404 is serving its intended purposes.

My first topic is—I want to emphasize for you based on my first-hand experiences—the three most troubling real problems that 404 has caused.

First, as you well know, public companies are experiencing at least a doubling of out-of-pocket audit costs. We all know, and it has been well documented, these costs are disproportionately burdensome to the smaller public companies.

The second problem that sometimes doesn't get as much attention is substantial internal human resources must be devoted to 404 compliance. This is especially problematic for smaller companies who, even though they have highly qualified CFOs as controllers, these persons must also play key roles in operating and grow-

ing their businesses. Compliance takes away from their ability to enhance shareholder value.

The third problem is that 404 has been a major contributor to a deteriorating relationship between public companies and their independent outside auditors. If companies have to ask their auditors for advice on how to account for certain items, the simple act of asking the question has raised the risk that the company would be deemed to have a material weakness in their internal control even though the outside auditors often didn't have definitive answers either. So companies stopped asking questions. They use their best judgment or hire a different audit firm for advice, even though that second firm doesn't know their business as well as their main auditors. This is not healthy in light of increasingly complex accounting rules.

These problems have also had more far-reaching consequences as some of my fellow panelists have noted. Public companies are increasingly looking at going private. For smaller public companies, their boards and officers would probably not be prudent fiduciaries if they didn't at least examine the going-private alternative.

Also, successful private companies and dynamic new ventures have virtually no aspiration to go public, regulatory burdens being the number one obstacle. When I talk to potential clients and existing clients about going public, they dismiss that idea out of hand.

Thirdly, even investment banking firms are looking for ways to avoid SEC registration for their clients by setting up unregistered stock trading systems. These developments are not healthy for small companies that want to grow by accessing the public capital markets or for U.S. markets in general.

My second primary topic is whether the new standards will effectively alleviate these most troubling 404 problems. I want to commend the SEC and PCAOB on their extraordinary efforts in identifying and analyzing these problems. I believe, and my clients seem to agree, these new standards do an excellent job in theory to address the above problems. However, a high level of skepticism exists as to whether the new standards will work in actual practice.

Out-of-pocket audit costs are not expected to reduce significantly, by 10 to 15 percent at best. One of my small non-accelerated filers has already been told by its accounting firm that instead of having a 125 percent increase in audit fees, it may only be 100 percent; i.e., a doubling of their cost. Also, no substantial reduction at all is expected in the internal resources needed to comply with the new rules. And then, most importantly, significant concern exists whether the outside auditors will buy into the new standards.

Without auditor buy-in, these standards can't work. Company officers realize that the auditors have all the power, and they have to do what the auditors want in order to obtain a clean 404 audit report. The SEC and PCAOB can only strongly emphasize to auditors the importance to buy in, but the regulators are probably limited in their ability to do this.

Also accountants likely and reasonably are concerned about their risk of liability, and perhaps some protection from liability would be warranted here as well. I think everyone who has spoken here today, except the SEC and PCAOB, have agreed that more time is needed for implementation. I certainly echo that feeling. With re-

spect to 404(a) and 404(b), management cannot put these controls in place without knowing their auditors are going to sign off.

Lastly, I want to ask the committee to continue to evaluate the bigger picture of Section 404. Cost effectiveness is not the only problem. My conversations with officers and directors of public companies are uniform; they do not believe that 404 has significantly improved the quality of their financial reporting. Rather, they think it has created a lot of additional documentation, much of which is minutia. They also believe that they had good internal controls before 404 came into play and continue to do so. And perhaps most importantly, they are adamant that 404 will not prevent another Enron type fraud.

In summary, I would like to say, the implementation of 404 has been a significant burden for public companies, particularly smaller ones. While the new standards provide some relief, 404 compliance is likely to be burdensome on public companies for years to come. Small public companies need more time to comply, if not a permanent exemption. And lastly, the jury should remain out and continue to evaluate whether 404 works at all. I appreciate the opportunity to have addressed these issues with you. I will welcome any questions that you might have. Thank you.

[The prepared statement of Mr. Schmalzl may be found on page 111 of the Appendix.]

ChairwomanVELÁZQUEZ. Thank you.

Professor Scott, I would like to address my first question to you. You chair the Capital Markets Regulation Committee and you examined the high cost of SOX 404 compliance and even recommended that smaller public companies should not be directed to implement SOX 404 until compliance costs are contained. In fact, your committee recommended a thorough cost-benefit analysis of SOX 404 should be conducted before a small company would be directed to become SOX 404 compliant.

In your estimation, how long will it take to conduct a thorough cost-benefit analysis of the new standard, and what sort of data should be collected?

Mr.SCOTT. I am going to give you my guess on these questions because I have not really thoroughly considered them and talked to a lot of people. But I would say that this certainly could be done within a year. We would need a year of actual implementation of these standards to large companies, to all companies other than the small companies, so we could assess what the impact would be. As I said, during that period, what we should be doing is looking at the closest cohorts to the small companies, the $75 million to $100 million companies, because that will give us a pretty good idea of what the impact is going to be on the smaller ones. Also, during this year of implementation to the large companies, which under the SEC's proposal won't fully be done until statements are filed in 2009. So I would say that we are really talking about doing this between 2007 today and during 2008. And I think, in addition to kind of getting information from the closest cohorts, they could interview in depth small companies. I sit on a board in which the auditors come forward, as does management, and tells us what it is going to cost. And I think we could have the SEC and PCAOB

interview these small companies and ask them directly, what are these standards going to cost you? What are the auditors going to charge? How would you estimate the time and effort management was going to spend? And as I said, Madam Chairwoman, the highest percentage of these costs is for management. So it is really no answer to tell us that we are going to defer the auditing piece of this for small companies and implement the management piece let alone the problem that a number of us have referred to, that the management is left high and dry without any real comfort from the auditors because they are not going to have to be Section 404 compliant for another year.

ChairwomanVELÁZQUEZ. Thank you.

Mr. Hirschmann, you heard me asking this question to Chairman Cox regarding the fact that under the existing time line smaller public companies will not have to issue SOX 404 compliance financials until the spring of 2009. Corporate executives however will not sign a management report without an auditor's attestation. Will you find small companies have to comply with both standards in advance of the December 2007 deadline?

Mr.HIRSCHMANN. I think the result is predictable here, unless we grant the delay. I think it is a very good question. I think what you will see is that companies will have two choices: Either they will go ahead and get their auditors involved, and because this is coming out late in the year, they will have to compete for attention of the auditors and may have trouble doing so because the audit firms are not fully staffed yet to provide that for smaller companies this year. So they will have a very difficult environment with a very high cost if they try to go that route.

Or they can try to do it without their auditor. But if they do that, they risk that next year their auditor will come in and say, wait a minute, what you did last year was not adequate; we are finding material weaknesses here. And that is an invitation for lawsuits and litigation and impacting the price of stock and really setting back the entire company. So you are really putting small businesses with two bad choices.

ChairwomanVELÁZQUEZ. Thank you.

Mr. Greenwood, I know that your members, many of which are small research and development companies, are particularly concerned about the cost of complying with SOX 404. Since the new standard of scalable and principal-based, why aren't they sufficient to address your members' concerns about high compliance costs?

Mr.GREENWOOD. Thank you. Fundamentally because, without the objective standard of using market capitalization and/or revenues, we think what will happen is that, given that the auditors have double incentives to maximize the compliance requirements— one, their fees; and, two, their liability—they want to err, their tendency is to err on the side of requiring more. So that is why we fear that our companies will not gain access to the scalability benefits of the changes.

One of the things that is unique about our companies, I think unique entirely to the sector, is that a biotech company may begin with a molecule that its scientists think will cure some kind of cancer. They then have years of research and years of development. Then they go into phase one clinical trials, phase two clinical trials,

phase three. They make an application before the FDA. They may have another year to wait. All of that might take 10 to 12 years or more and may cost hundreds of millions of dollars and yet they haven't earned a penny in all of that time of revenue. And so, if you think about it, I had the honor to chair when I was chairman of the Oversight Investigation Subcommittee, to chair investigations into companies like Enron and Global Crossing. And what would those scandals have been? They were largely about officers of companies who had stock options who wanted to exercise those stock options, who wanted the value of the stock to continue to inflate, who falsely stated earnings and revenues in an attempt to meet the street's requirements and keep the stock pumped up. That doesn't apply to these companies. These companies have no revenues. They have no earnings. They only have investment. And when you take a company that needs to spend all of its money on research and development and then take significant segments, sections of those invested dollars and use it for compliance that provides really no value to the investor, it is truly overburdensome. The final thing I would say on that, Madam Chairman, is that what our companies tell us is that, when potential investors ask them about Sarbanes-Oxley compliance, it is not because they want to know how well protected they will be as investors. It is because they want to know how much money the company is wasting on SOX compliance.

ChairwomanVELÁZQUEZ. Thank you.

Ms. Casey, you mentioned in your testimony about the management of some community banks indicating that they are seriously considering delisting. Can you talk to us, rather than incurring the cost of SOX 404 compliance, can you talk to us about what are the negative consequences to a community if their bank chooses to delist?

Ms.CASEY-LANDRY. Three years ago, we partnered with NASDAQ to create an index for community banks to provide more visibility in the capital markets for community banks and to facilitate their ability to raise capital. What we have found is, at the same time we did that, Sarbanes-Oxley came along. And so the cost of being a public company suddenly rose dramatically as the banks that were public were facing both the audit costs as well as the 404. Because the index comprises some banks that are accelerated filers, they have already been in compliance positions. But as they began to look, the same statement that was just made by my colleague up here, Honorable Greenwood, about companies looking at what the investors were saying, they are not saying, what is the value of the 404 to improve the financial statements? They are saying, are you taking away that investment that can go back into the community, go back into the institution and will we be better off being a private company? And so the decision really hinges on whether or not the institution believes it can better serve their community and stay serving that community and not be forced to sell out. And some of them are making a decision to stay independent, to stay as a community bank, they would be better off being a private company, keeping those costs for the institutions and not spending it with their auditors.

ChairwomanVELÁZQUEZ. Thank you.

Mr. Heesen, I just will say that Section 404, Sarbanes-Oxley 404 is the best protection that a venture capitalist like yourself and your members will have regarding corporate fraud. And yet I am impressed by how forceful you have been in advocating to delay this implementation of SOX 404. Can you explain?

Mr.HEESEN. Absolutely. I do not know of a single venture capitalist who would say the advantages of Section 404 outweigh its disadvantages. And that is as an investor talking. A venture capitalist wears two hats. He is an investor as well as he sits on a board. But I do not know literally of a single venture capitalist who would say the benefits outweigh the problems that have been associated with 404. It is a drain on the resources of the company. It is unquestionable. The money needs to go one place in a merging growth company, and that is into R&D. You want to grow that company and make it as competitive as possible as quickly as you can. If you have money being diverted to Sarbanes-Oxley's cause, that is money being diverted from R&D. Basically that is a competitiveness issue, very simply. But it also demonstrates that our companies today take longer than they ever have to go public. And most importantly, more and more of our CEOs are saying it is not worth going public; I would rather get acquired. Now you are still going to have to be Sarbanes-Oxley compliant to be acquired, but they are just saying it is not worth it to basically be in charge of a company that I am basically a babysitter for regulation instead of a company builder. And so they are selling out. And that is not good for the economy at the end of the day.

ChairwomanVELÁZQUEZ. Thank you.

Mr. Chabot.

Mr.CHABOT. Thank you very much, Madam Chair.

Mr. Schmalzl, I'll start with you if to I can. You have mentioned before that many of the companies that you are dealing with are very hesitant, if not I think it is maybe laughable to go public when one considers the additional burdens that are imposed. Would you kind of discuss maybe philosophically or with the economy in mind, what does it really matter whether companies stay private or whether they go public? What does that mean in the overall scheme of things? We are a capitalist society obviously and want people to be participatory in business and that whole thing. Could you talk about that a little bit?

Mr.SCHMALZL. Sure. I have always viewed the main reason for a company to go public is that they want to be able to grow their company. And being able to access the public capital markets has been the most effective way of getting capital to grow your company. Also that provides advantages for the investing public as companies. You know, numerous—Microsoft, Google. As the individual investors and institutional investors can share in that growth, I think that is good for everyone. With the public markets effectively being closed to these growing companies who otherwise might be considering it, I think we are cutting off a lot of opportunities for those businesses, for the employees who work in those businesses because their growth is stunted. And I agree with Mr. Heesen on the inability for—you know, if these companies end up being acquired by larger companies, the adverse effect on their in-

novation isn't the same. I think we need to grow our own. And if going public isn't a viable option for these companies I think we feel the effects of that in a variety of ways across our economy.

Mr.CHABOT. Thank you. And Professor Scott, I noticed you nodding. I don't know if it was the question or the answer. But I would be happy to maybe throw you that softball, too, and ask you to comment upon it. And maybe also keeping in mind what Mr. Schmalzl also mentioned: It is not just the investors; it is also folks that maybe would never fathom investing but ultimately are going to need a place to work and support their families and that sort of thing.

Mr.SCOTT. Right. Another aspect of this problem which the committee thought was quite important was the fact that venture capitalists, in order to create incentives for them to invest, want to have a public exit. This has been the dream. The venture capitalists come along, they invest. They nurture the company, and the company goes public, and over a period of time, the venture capitalists cash out and make money.

Now, if that result is limited because of the unattractiveness of the public markets, what we are going to see is less investment on the front end by venture capitalists and small companies because this investment is going to be less attractive to them because they can't cash out in the public markets because of some of the costs that we have been talking about. And this is fundamental. This investment fuels this economy. Anything we do to interfere with it is a very serious matter.

Mr.CHABOT. And is it accurate to say that we are trying to maintain some balance, because obviously if people are buying stocks in companies or they have their pensions invested in that company and people are crooked or doing things that they shouldn't be doing, we want to protect them, but at the same time not kill the goose that created this wonderful economy or America that we enjoy.

Mr.SCOTT. Right. I totally agree with that. We are not just focused on the cost, we are focused on the cost-benefit relationship. So the issue here is whether the benefits from 404 exceed the costs. And those benefits that we are talking about are to investors. That is why it is incumbent on the SEC to do a very thorough empirical analysis of this issue before we implement.

Mr.CHABOT. Jim, let me start with you on this one if I can, and we will just go down, anybody that would like to comment. I'll make this my last question so we can get to some other members. I believe you were all here, correct me if I'm wrong about this, when both Chairman Cox and Chairman Olson testified. Everybody was here I think during that. Could you tell me what are one or more, depending on how you want to take this, things that were said that you disagree with or that you take issue with or that concern you about what you heard when it comes to business and how 404 and all this affects businesses in our communities around the country.

Mr.GREENWOOD. I think, Ranking Member, that the point that I thought is most important in this entire hearing is really about the loss of the quantitative threshold for smallness. Mr. Olson's testimony was that they originally thought that was a good idea and

then, in reevaluating, it seemed not flexible enough. And I would agree with him if the issue is, well, there are companies that might exceed a $75 million revenue threshold that are also very simple. And if that is the case and if the PCAOB said maybe we want to give auditors the opportunity to look at a company with $80 million or $100 million in revenue that has very simple financials and also incorporate them into this more scalable methodology. That is not what they did.

What they did is they did away with the quantitative threshold all together. And we think, without that, as I mentioned earlier, we think without that auditors will opt for a more complex review and that it will be of extreme cost to the companies really debilitating their abilities to do their research and development and providing little if any additional protection for investors.

Mr.CHABOT. Thank you.

Ms. Casey-Landry.

Ms.CASEY-LANDRY. Thank you, Ranking Member Chabot. I think the comment that struck me the most was during the questioning with the chairwoman regarding implementation of 404(a) and 404(b). The reality is that we are already in the fiscal year for community banks and for any company. And the guidance isn't finalized. It still has to go through the OMB process, and then it needs to be out there. And I think the biggest challenge that Chairman Olson and Chairman Cox need to recognize is, once this is approved, that giving speeches and passing out pamphlets is not going to be enough to educate the profession with respect to how to handle 404 compliance for smaller companies, and at the same time, these smaller companies will have to begin to undertake the management review of their internal controls. And like everybody else said, banks are regulated by other entities, and they are not going to sign off on an internal controls report for their bank regulators much less for their auditors without these things being right. So I think the 1 year extension is absolutely critical.

Mr.CHABOT. Thank you.

Professor Scott.

Mr.SCOTT. Three points. First of all, adopting 404 for small companies without a thorough cost-benefit analysis in advance of the adoption. Second, bifurcating the implementation of the management and auditor standards in two different years. And third, not adopting a quantitative standard for materiality in the guidance.

Mr.CHABOT. Thank you very much.

Mr. Heesen.

Mr.HEESEN. I was, frankly, very surprised at the total lack of recognition that this regulation rule actually has to be implemented and that accountants are going to implement this and that you can have anything you want on paper. But if the accounting community doesn't actually want to implement this, they are not going to implement it. And I think that is an issue that is not being addressed at all. I think that as it stands right now, the big four are holding a lot of cards here. And if they don't want to see these changes implemented, they are going to have the power not to implement them. And no one that I heard from either the SEC or the PCAOB are talking about what I view as a very basic issue here, and that is implementation of these things.

Mr. CHABOT. Thank you.

Mr. Hirschmann.

Mr. HIRSCHMANN. I have three quick points. First is, I was surprised to hear Chairman Cox say that he feels like he is close to the finish line. I really think this is an important step, but we are not yet at the finish line. And the implementation is important. I would hope that the SEC and the PCAOB would open to make additional changes if needed. Second, with regard to the PCAOB and the inspections process, until auditors feel that they will not be second guessed, if they simply don't repeat what they have already been doing, I don't think you can expect auditors facing huge liability to change the way they approach. So a change to the inspections process at the PCAOB is very important. And third is the cost-benefit issue. And I would just point out, there are a lot of good people working at the SEC. It is a good agency. But the ability to conduct a cost-benefit analysis is a material weakness at the SEC. They simply cannot do it consistently well. It is been the subject of litigation which they have consistently lost and this is just another proof that they don't have the ability to do it.

Mr. CHABOT. Thank you. Finally Mr. Schmalzl.

Mr. SCHMALZL. Yes. I would echo all the same points. First, I was a little dismayed that it seemed to me that Chairman Cox really didn't understand in practice what it takes to comply with 404(a). The internal resources needed that management needs to devote to that process is significant regardless of whether or not you add the out-of-pocket audit cost to that.

Second, I didn't think there was enough credence given to how much power the auditors have in this process. Unless the SEC and PCAOB can get some confidence that the auditors are going to buy into these standards, I think the people I talk with at public companies really think that the process is futile unless the auditors buy in.

And then, thirdly, I believe the SEC pretty much assumes at this point that 404 is working and that it prevents fraud and that it is creating investor confidence. My clients clearly do not believe that. Their feeling is that the market really doesn't care about these reports and that, as others have said, what they care about is, how much is it costing you to obtain that report? So I think that, to the extent that the SEC or PCAOB have essentially declared victory on the 404 point, I think that is mistaken.

Mr. CHABOT. Thank you very much. I want to thank the entire panel for their answers. I yield back.

Chairwoman VELÁZQUEZ. Mr. Ellsworth.

Mr. ELLSWORTH. Thank you, Madam Chairwoman.

Thank you all for coming. It is very informative, for you holding the hearing and for you all testifying. I found it fascinating. I guess, first, a couple of observations. One, we keep talking about an extension. And I come to find that if people just give me bad news and tell me, if they come up and tell me, hey, I am going to punch you in the nose right now or punch you in 5 minutes, I still bleed and my nose still hurts 5 minutes later. And so just an extension doesn't sound like a fix. Is it fair to say that no one on this panel believes that we can achieve the intended goal of 404 the

way it is written right now? I think I am safe in assuming that we are not achieving the goal. And I see some heads shaking. If you can give me that nod I'll take that as the affirmative.

So those two observations being said, I don't know, Professor, maybe you are the first one or Mr. Hirschmann, I don't know; what is the fix? If I gave you the magic wand or the magic pen, you know what we want to do, or what was intended here? What is the best way? Do we make it go away totally, wave the wand and make it go away, or what is the bullet point fix on this?

Mr.SCOTT. Well, I think there should be a two-stage fix. The first stage is that we should adopt reforms, part of which have been done, but more that need to be done, particularly a quantitative materiality standard. And then field test this in terms of the cost and benefits to small companies. Now, if the costs still outweigh the benefits, which they may well be, then I think the Congress has to address this. What our committee said is, in that event, what the Congress should do is to exempt small companies from the auditor attestation requirement. At the same time, however, because management would not have the comfort of this outside auditor opinion, that the certification standard that management now has, which is pretty high, be lowered in terms of what management would really have to say about their confidence in the internal controls.

But before we ever get there, Congressman, I think the first step is, let's do whatever we can to make this a more efficient system. And I think there are steps yet to be taken. And when we do that, let's figure out what the cost benefit is, a thorough study, for small companies. And only if that doesn't work should the Congress come back into the picture.

Ms.CASEY-LANDRY. May I just point out that the bill that was introduced by Representatives Greg Meeks and Tom Feeney would provide an exemption for smaller companies. And I think that would be something that would be worthy of Congress considering. But that is a broader question and some other committees get involved in that.

Mr.HIRSCHMANN. I do think they are trying to fix the problem. And part of the challenge is they don't have the tools in their hands to completely solve the problem. They can certainly fix the implementation of 404. What they cannot do is address the rest of the equation which is the complexity of our accounting standards, the fact that accounting rules are increasingly complex, interpreted retroactively, they are forcing one in ten public companies with an escalating number every year to restate their earnings. The whole litigation environment around auditors, there is a bigger picture here that goes beyond 404. And I don't think until you address all those pieces you can really ultimately solve this for anybody.

Mr.GREENWOOD. I would reiterate that the real fix is probably to go back and provide a complete exemption for the smaller companies. And I would base that on revenue, not on market capitalization because market capitalization can, A fluctuate wildly. A biotech company may have a drug. And based on the promise of that drug, its stock value may be here. And in clinical trials, it doesn't prove out to do what the company hoped it would. So the market cap drops precipitously. There are still no revenues coming

into the company. So I would use a revenue test for exemptions. And Congress should certainly seriously consider doing that. And I don't think that it would be, as somebody who has spent 24 years in public office, I don't think there would be a public reaction that would be negative. I think people instinctively understand that small companies are not the Enrons and the Global Crossings and the WorldComs.

Mr.SCHMALZL. I would like to add to that I would agree that a broader exemption for small public companies defined in a different way would be a big advantage. And I think there should be a net revenue and/or gross revenue test attached to that. Also I would like to say that I am not at all negative on Sarbanes-Oxley. I think Sarbanes-Oxley has done an awful lot of good things for public companies. Boards of directors are more effective. Audit committees are much more effective. There is more information into the factor faster. Those are all very good positives about Sarbanes-Oxley. And I think we achieve all of those without 404 and without the incredible costs associated with 404. So I wouldn't rule out the possibility of appealing it for everybody. But if we are not going to do that I would certainly try to exempt out a larger batch of those smaller companies, particularly ones that are still struggling to get to a revenue level that really can support these kind of costs.

Mr.HEESEN. I just look at it from the angle that the SEC, Small Business Committee that looked at this issue came up with these kinds of proposals. They were rejected basically by two very strong votes, and that was the accounting firms. And so I think, once again, you have to look at this and say, what at the end of the day will the accounting industry feel comfortable with that businesses also can feel comfortable with? And that is a hard balance. But even from our companies, companies that are going to be acquired today, I don't care how big or how small they are, they are going to have to be Sarbanes-Oxley compliant. A bigger company is not going to acquire a smaller company unless all the Is are dotted and all the Ts are crossed. It is just too much liability coming in. And so this goes beyond simply trying to say, let's exempt X amount of companies and it will solve everything, because frankly it won't.

Mr.ELLSWORTH. Thank you all very much. I yield any time I might have.

ChairwomanVELÁZQUEZ. Thank you.

Jim, you spoke about the cost for your members in terms of Section 404. My question to you is, does your organization plan to collect data that quantifies compliance costs for new members before and after the new standards are in place. And if you are going to do that, would you be willing to share that data with us.

Mr.GREENWOOD. Absolutely we would be willing to do that. We have lots of anecdotal data, some of which we have shared with your staff, Madam Chairwoman. But we would certainly be looking forward to working with your committee on compiling data with our members that would be helpful in your decision making.

ChairwomanVELÁZQUEZ. Thank you.

Mr. Heesen, several studies have cited evidence that the U.S. stock markets are becoming less competitive, and some have suggested that expensive regulation, including Section 404, may be partly to blame. In fact the mayor of New York, Mr. Bloomberg, re-

leased one of those studies. Can you comment on the relationship, if any, that you see between SOX 404 compliance and the apparent increase in the number of firms deciding to list their shares on full markets.

Mr.HEESEN. I think part of it is Sarbanes-Oxley. I think it is unfair to blame Sarbanes-Oxley for everything. I think we are living in a much more global economy today. There are many foreign exchangers that are much better today than they were 5 years ago. Having said that, I think many of them have gotten better because of Sarbanes-Oxley. I think they have gotten much more aggressive in coming into the U.S. and marketing to our companies and saying please let's go public on AIM or on Tokyo or somewhere else. You are also seeing companies that venture capitalists have backed that may be based in another country that in the past would have gone public on NASDAQ and instead today are going public on the Bombay exchange or on the Tokyo exchange. Now, part of that is because they are in their home country. But the other part of that is because those exchanges have gotten better and smarter and much more aggressive than NASDAQ has because of Sarbanes-Oxley. So some of it actually is very much a part of Sarbanes-Oxley. Some of it is part of just globalization in general.

ChairwomanVELÁZQUEZ. Definitely. And I did not intend to say that it is just only to blame for Section 404, but is the cost of regulations, including Section 404. Professor Scott, do you mind to comment?

Mr.SCOTT. Yes. Of course, this was a major finding of our committee's report that a number of factors were leading our public markets to be less competitive. In addition to regulation in general, which you have observed 404 is part of, we have two other concerns. First of all, the cost of litigation here, which is very high on the list of why foreign companies do not want to come to the United States. And secondly, in view of our committee, a deficit in the rights of shareholders in the United States compared to our countries. For example, other countries permit their shareholders to vote on the adoption of poisoned pills which are an impediment to takeovers. Our public company's shareholders don't have those rights. We have a possibility of having plurality voting rather than majority voting. So I would say in addition to regulations the cost of litigation and the deficit in shareholder rights. That was the conclusion. And as Mark observed, foreign markets are becoming more competitive. The point is, we can't just do what we want to do anymore. This is a competitive world, and we have to accept that reality.

ChairwomanVELÁZQUEZ. Yes.

Ms.CASEY-LANDRY. I just wanted to make one comment. Community banks don't have the option to go to another exchange. And if they want to stay public and they want to have access to the capital markets then we need to have a system that is fair so that they can go to NASDAQ, they are going to go to the New York Stock Exchange, and they be listed and that they can be competitive. When we place undue burdens on smaller companies that can't go global then we are really affecting our own base and own economy. And I would just point out that 404 has been a problem. And at the same time you do have community banks. We just added an-

other 50 banks to our index in the past 6 months. But, I mean, banks that chose to go public. So there are companies that are still going public at the same time those are choosing to delist. But it is important to keep it domestically focused, too.

ChairwomanVELÁZQUEZ. Thank you.

Any other witness? Yes, Mr. Hirschmann.

Mr.HIRSCHMANN. I want to just agree with the point that there is a lot of good in Sarbanes-Oxley. But the168 words of Section 404 we refer to as the 168 words that stole the act. So I hope that not the final words. And I commend the committee for holding this hearing and look forward to working with you to make the changes that are needed.

ChairwomanVELÁZQUEZ. Thank you. Mr. Chabot.

Mr.CHABOT. Thank you, Madam Chair.

I just want to once again commend you for holding this hearing and thank you for doing so and thank the panel here. I thought they gave us some very insightful information. And I want to especially thank Mr. Schmalzl for coming all the way from my district back in Cincinnati, but I thought everybody here was really very good and we appreciate you holding this hearing.

ChairwomanVELÁZQUEZ. I echo the remarks made by the Ranking Member. It has been a great hearing, and I believe that, yes, there is so much good on Sarbanes-Oxley, but we have to make sure that we get it right. And I don't see the rush in terms of compliance right away without knowing and having the empirical data that shows that there is the cost-benefit analysis that will help the small companies to continue to grow and do what you do best in this country and our economy, and that is the research, the development, but at the end, job creation, and that is very important. So with that, I want to thank all of the witnesses. And members wishing to submit statements or documents into the hearing record will have five legislative days to do so. This hearing is now adjourned. Thank you.

[Whereupon, at 4:45 p.m., the committee was adjourned.]

STATEMENT
of the
Honorable Nydia M. Velázquez, Chair
Committee on Small Business
Full Committee Hearing on the Implementation of Section 404 of Sarbanes Oxley Act
Tuesday, June 5, 2007

I call this hearing to order. This afternoon the Committee will examine the implementation of Section 404 of the Sarbanes Oxley Act and consider whether the new standards that the SEC and PCAOB approved last month will lower compliance costs for smaller companies.

Small firms continue to be supportive of the intent of the Sarbanes-Oxley Act and many have benefited from the stronger corporate governance culture that it encouraged. However, what we have continued to hear is that these benefits – and particularly those associated with Section 404 – come at a very steep cost. This continues to make me believe that these new regulations should be delayed.

This additional time is especially important for smaller companies, which often operate with limited human and financial resources – and are disproportionately burdened by these high costs. We may jeopardize some of our country's most innovative endeavors if we fail to adequately balance investor protection with the associated regulatory burden.

Last month, new management guidance and an auditing standard for Section 404 were approved. The result of nearly 2 years of work, these new standards seek to make Sarbanes-Oxley compliance more efficient and cost effective for companies of all sizes. While I am encouraged by this, I am concerned about the proposed timeline under which small firms would have to comply with the new regulations.

Earlier this year, Ranking Member Chabot and I wrote to Chairmen Cox and Olson and expressed our concern that the proposed implementation timeline was inadequate to assess its effectiveness. Postponing the December 2007 and December 2008 deadlines by **at least** one year would allow for the new standards to be tested and for evidence to be collected that could confirm that the new standards do, in fact, lower costs for small firms.

Small businesses are significant sources of research and development, job creation, and innovation in our economy. It is critical that the SEC and PCAOB work to ensure that SOX 404 is implemented in a way that contributes to increased investor confidence – but that also does not hamper America's competitiveness. Postponing the compliance deadlines for at least an additional year would allow us to make this determination.

A delay would also provide for the training for small companies and also for auditing firms. It would also permit the PCAOB's efficiency inspectors to assess whether audit firms are implementing the new standards in the manner intended. At a minimum, these steps would help ensure a more effective implementation of these new standards – and recognize the unique situation that many companies find themselves in.

These new standards come at a time when small businesses are already spending 45 percent more than larger firms on regulatory compliance. To ensure that these burdens become more manageable, we should not be piling new regulations on until they have been thoroughly reviewed. Today's hearing will help us accomplish this – and by doing so – it will demonstrate that a delay is necessary to better balance the costs and benefits of these new standards.

I now recognize Mr. Chabot for his opening statement.

Opening Statement

Hearing Name	Sarbanes-Oxley Section 404: Will the SEC and PCAOB's New Standards Lower Compliance Costs for Small Companies?
Committee	Full Committee
Date	6/5/2007

Opening Statement of Ranking Member Chabot

Thank you, Madam Chairwoman, and thank you for holding this hearing on Section 404 of the Sarbanes-Oxley Act and its impact on small business.

The Sarbanes-Oxley Act has been described as the most important and far reaching securities legislation since the Securities Act of 1933 and the Securities Exchange Act of 1934, which were passed following the stock market crash of 1929. Signed into law in 2002 in response to the bankruptcy of Enron Corporation, the WorldCom scandal, and other corporate failures, the Sarbanes-Oxley Act established the Public Company Accounting Oversight Board (PCAOB), a private sector nonprofit organization that oversees public company auditors and enacts auditing standards. The Act also restricts accounting firms from performing a number of other services for companies which they audit, and requires new disclosures for public companies and their officers and directors.

While the Act has generally been viewed as necessary to restore public and investor confidence in our capital markets and improve the reliability and transparency of corporate financial reports, concerns have been raised about the burden and cost of compliance for small and medium-sized companies. One of the most controversial provisions, Section 404, Management Assessment of Internal Controls, requires management and auditors to assess internal controls over financial reporting, and requires external auditors to report on management's assessment and certify the to the effectiveness of internal controls.

According to an April 2006 Government Accountability Office study, small businesses expend a disproportionately greater amount of time and money (as a percentage of revenues) complying with Sarbanes-Oxley than large public companies. Firms with $1 billion or more spend thirteen cents per $100 in revenue for audit fees to comply with Sarbanes-Oxley regulations, while small businesses spend more than $1.

It is generally agreed that Sarbanes-Oxley has had a positive effect on investor protection and confidence. But its burden on small business has not only affected their bottom line, but also their competitiveness in our global economy. GAO found that small businesses used resources for Sarbanes-Oxley compliance rather than for other business activities. A recent Kauffman-RAND Center for the Study of Small Business and Regulation said that Sarbanes-Oxley caused small firms to exit the public capital market.

Last year, the Securities and Exchange Commission (SEC) announced that it would delay the application of Section 404 to the smallest companies until later in 2007. Earlier this year, the Chairwoman and I urged the SEC to delay implementation of the new internal controls standards to allow small businesses additional time to comply. On May 23, 2007, the SEC announced it would not allow such an extension.

At its May 23, 2007 meeting, the SEC adopted rules designed to reduce costs for compliance with Section 404 for all businesses. In addition, the Commission adopted proposed rules examining the general disclosure requirements for small companies wanting to go public. This represents an excellent opportunity for the Commission to examine the cumulative impact of its rules on small companies and reduce those while still striving to maintain investor confidence.

Madam Chairwoman, I commend you for holding this hearing on Section 404 compliance. I want to note that in addition to our panel of experts, we have with us an attorney from Cincinnati who has real world experience in helping small public company clients to deal with the challenges of Section 404 compliance. I look forward to hearing from each of our witnesses.

TESTIMONY OF CHRISTOPHER COX
CHAIRMAN, U.S. SECURITIES AND EXCHANGE COMMISSION

AT HEARING ENTITLED
'WILL THE SEC'S AND PCAOB'S NEW STANDARDS LOWER COMPLIANCE COSTS FOR SMALL COMPANIES?'

BEFORE THE
COMMITTEE ON SMALL BUSINESS
U.S. HOUSE OF REPRESENTATIVES

June 5, 2007

Chairwoman Velázquez, Ranking Member Chabot, and Members of the Committee:

Thank you for inviting me to testify on behalf of the Securities and Exchange Commission concerning the application of section 404 of the Sarbanes-Oxley Act to small businesses.

This Committee's charge is a vitally important one, both to the millions of small businesses in America, and to our economy. For our part, the SEC is charged by statute with the protection of investors, fostering efficient markets, and the promotion of capital formation. Small business needs all of these to survive. Like every Member of this Committee, we are completely committed to fostering a climate of entrepreneurship that helps promote small business growth, and the creation of the many jobs and goods and services in our country that are produced by small business.

For a small business, raising private capital often depends upon the future viability of tapping the public markets. It isn't just the company that is ready to go public today that benefits from a healthy market in publicly traded securities. Every startup, every new business idea – every determined woman with a dream, and every man striking out on his own – needs a flourishing IPO market.

America creates far more new businesses than does Europe. And our capital markets have a far higher percentage of individual owners of securities. So it's essential for the vitality of our economy that we protect both the opportunity for small businesses to raise the capital they need to innovate and the savings of individual investors that are invested in the securities of public companies.

Today, nearly five years after the Sarbanes-Oxley Act was signed into law, over 6,000 public companies still aren't required to provide the audited internal control disclosures required by section 404. Generally, every public company with securities registered with the Commission, if it has less than $75 million in public equity, falls into this category. They haven't been required to comply with section 404 because the Commission has been

very sensitive to the special concerns of smaller public companies. All other public companies in the United States already have three years of reporting on internal controls behind them.

The Commission has delayed section 404 compliance for smaller companies because of the disproportionately higher costs they face compared to larger companies. Our experience of the first three years told us that the way 404 was being implemented was too expensive for everyone – and imposing that system on the smallest companies would impose unacceptably high costs from the standpoint of the companies' investors, who would have to pay the bills.

So the Commission and the Public Company Accounting Oversight Board set out to address the unique concerns of small business. We further delayed the implementation of 404 for smaller public companies until Chairman Olson and I, working together with the full Commission and the PCAOB, could replace the current inefficient system of 404 implementation with a more streamlined approach.

Our intention all along has been to re-focus 404 compliance on the specific problem that Congress had in mind: material risks to the financial reporting system. In that way, we will better protect investors and companies will more wisely spend their money on more meaningful internal control audits. And I am pleased to report to you today that the Commission and the PCAOB have voted to completely replace the inefficient system you have heard so much about with new guidance for management and a completely new standard for auditors.

In a moment, Chairman Olson will talk about the particulars of the PCAOB's new auditing standard, Auditing Standard No. 5 (AS 5), which, if approved by the SEC, will replace Auditing Standard No. 2 (AS 2). But I can tell you that the SEC and the PCAOB worked closely together on the development of this new standard to eliminate any language that would create an expectation that a small business's controls would have to be designed to fit the audit, rather than the audit being designed to fit the controls. AS 5, and the Commission's recent revisions to certain rules in Regulation S-X, also make clear that auditors are not opining on the methods or on the procedures that a small business uses to evaluate its internal controls. Rather, they are opining on the effectiveness of the internal control structure and procedures.

The replacement of AS 2 with a completely new auditing standard is vitally important to small business, because the prospect of being required to undergo the same kind of expensive internal control audit that large companies faced under AS 2 was the part of the 404 process about which smaller companies had complained of the most.

The SEC and the PCAOB also worked together on something brand new, that small business and companies of all sizes have never had before: specific guidance for management about its role in assessing internal controls, as distinct from the role of the auditor. This kind of guidance simply did not exist before. Rather, companies were

forced to rely on standards for auditors, not companies, and those standards were themselves heavily criticized for being overly complex.

As a result, we now have SEC guidance expressly intended for management that is already finalized. And in a matter of months, I expect that the nation will also have a new SEC-approved auditing standard for auditors to use in their implementation of SOX 404.

The focus of this hearing is on whether the SEC's new guidance for management, and the PCAOB's new standard for auditors, will lower compliance costs for small companies. The answer is yes.

We expect the unduly high costs of implementing section 404 of the Act under the previous auditing standard will come down. They should come down because now, a company will be able to focus on the areas that present the greatest risk of material misstatements in the financials. This is what the law has always intended we be focused on. It's also what investors care about. It's what's important for achieving reliable financial reporting.

Compliance costs should come down because the new SEC guidance that's been developed specifically for management will allow each small business to exercise significant judgment in designing an evaluation that is tailored to its individual circumstances. Unlike external auditors, management in a smaller company tends to work with its internal controls on a daily basis. They have a great deal of knowledge about how their firm operates. Our new guidance allows management to make use of that knowledge, which should lead to a much more efficient assessment process.

Compliance costs should also come down for the minority of smaller public companies that had already complied with section 404 under the old auditing standard. In recognition of the fact that many of those companies have already invested considerable resources in the design and implementation of their processes, the Commission's guidance does not disrupt or require any changes to what they are now doing. While these smaller companies should benefit from the top-down, risk-based, materiality-focused, and scalable nature of both the SEC's new guidance and the PCAOB's new auditing standard, they should not have to expend new resources to do so.

The Commission has also made clear that our new guidance for management provides one way, but not the only way, to comply with the 404 requirement for an annual assessment of internal controls. We've made it clear that management can follow other reasonable approaches, too. For those managements that do follow the basic approach described in our guidance, we've adopted a rule that gives them the comfort of knowing that by doing so they have satisfied their obligation to evaluate their internal controls.

It is our intention that the SEC's new 404 guidance for management and the PCAOB's new AS 5 will work together to clearly delineate the company's responsibility for the methods and procedures it uses in its internal controls evaluation process, on the one

hand, and the auditor's responsibility for opining on management's assessment, on the other hand. In combination, the Commission's guidance and the PCAOB's new auditing standard should result in management using a top-down, risked-based approach to its evaluation of internal controls. And they should shift discussions between managers and auditors away from management's evaluation process to what matters most to investors – the risk that material misstatements in the company's financials won't be prevented or detected in a timely manner.

By the way – managers and auditors *should* talk. And not just managers, but audit committees should have a healthy and ongoing dialogue with their auditors about the company's internal controls. There is no auditor independence rule, or any other rule or standard, that stands in the way of this kind of useful communication.

The comment periods for both the Commission and the PCAOB proposals closed on the same day – February 26 of this year. The Commission received 205 comment letters from a broad cross-section of investors, small companies and large companies, accountants, lawyers, regulators, and academics. About 70% of the respondents to the Commission's proposed guidance also provided comments to the PCAOB on its proposed auditing standards. The percentage that commented to both of us would have been higher, except that we received 48 letters from a class at the University of Wisconsin, who inexplicably found writing to the SEC a more appealing assignment than commenting to the PCAOB.

In our outreach to small business throughout this process, the SEC has been aided by the exceptional work of our Office of Small Business Policy in the Division of Corporation Finance. The Office of Small Business Policy is focused on making sure that the unique needs of small business are reflected in our rules, and in the interpretations and guidance we provide to the public. The Office of Small Business Policy served as the secretariat for the Commission's Advisory Committee on Smaller Public Companies, which issued its report to the Commission in April 2006. That report was focused on the problems with section 404 implementation in a systematic way, and it has informed many of the solutions that we are now preparing to put into effect.

Two months ago, as we neared the completion of our work on our 404 implementation reforms, the Commission held an open meeting to review the general nature of the public comments and the remaining open items that needed to be addressed. Chairman Olson and Jeff Steinhoff, the Managing Director for Financial Management and Assurance at the Government Accountability Office, also participated in that meeting.

Now that the SEC and the PCAOB have finished this collaborative work, and the SEC's new guidance for management is approved, all that remains is for the new PCAOB standard to be exposed for public comment under the SEC's own approval process. I expect that AS 5 will be approved in final form this summer, but if it is not, we'll once again postpone the requirement that smaller public companies have a section 404 audit until the new auditing standard is available, with plenty of time for them to prepare.

Of course, the reforms that we have made can be successful only if they are implemented properly by companies and their auditors. The manner in which the PCAOB conducts its inspections of auditors will be of critical importance in influencing how auditors implement the new AS 5. The Commission will be carefully monitoring the implementation to ensure that the sought-after cost savings are achieved.

As this Committee is aware, the Commission has carefully phased in application of the 404 reporting requirements. We have repeatedly deferred 404 compliance for small companies. The very positive result of our determination to phase in 404 for smaller companies is that we and they have had the opportunity to field test the requirements first. Now, we're using what we've learned to lessen the burden for smaller companies that will eventually have to comply with 404.

We have little doubt the SEC's new guidance and the new PCAOB standard will be of significant help to small companies when, beginning with their SEC annual filings in 2009, they eventually comply with the audit provisions of 404. In the meantime, for their filings in 2008, they will have to comply only with the management assessment portion of 404. And for this purpose, our new guidance will be especially helpful. It's written in plain English. It suggests that certifying officers at small companies ask themselves two basic questions:

First, do my employees understand what they need to do to prepare reliable financial statements?

Second, what information do I need to be sure they've done those things?

The answers to these questions needn't be complicated or costly. And certainly our guidance won't make them so. In fact, the guidance clearly highlights the areas where cost-effective implementation has been a challenge for small companies in the past, so that these pitfalls can be avoided. And it explains how a small company might approach 404 differently than a large company. For example:

- A smaller company would probably follow fewer and different steps in evaluating whether its controls will provide reasonable assurance about the reliability of its financial reports.
- Management in a smaller company can go about obtaining information on whether its controls operate as designed in different and less elaborate ways than would be necessary in a large company.
- The documentation needed to provide reasonable support for a smaller company's controls will normally be less than what's required in a larger company.

None of this should be unduly difficult for most small companies, and it most certainly does not require the 404 audit that has had smaller companies so concerned about cost.

As we meet here in mid-2007, the requirement of an internal control audit under section 404 won't apply to smaller public companies with calendar-end fiscal years until their filings in the spring of 2009, almost two years from now. In the meantime, those smaller companies can begin to get ready for full SOX 404 compliance by undertaking the company's own assessment of its internal controls, beginning with their SEC reports in 2008.

So in response to suggestions that the Commission should extend 404 compliance for another year, the answer is that smaller companies won't be required to come into full compliance with SOX 404 until their reports due in March 2009.

This schedule gives smaller companies the benefit of doing an initial internal assessment of their controls without the added burden and cost arising from an external audit. We fully expect that, by the end of 2008, management's familiarity with the 404 process, and its documentation of internal controls, will make it easier and less expensive to do an external audit than it would have been under the previous system.

The goal of our collective efforts in this area is to implement section 404 just as Congress intended: in the most efficient and effective way to meet our objectives of investor protection, well-functioning financial markets, and healthy capital formation by companies of all sizes. We won't forget the failures that led to the passage of the Sarbanes-Oxley Act in the first place. And we won't forget that for small business to continue to prosper in America, both strong investor protection and healthy capital formation must go hand in hand.

The reforms we're making to the SOX 404 process are intended to be of direct benefit to America's small businesses – and the millions of Americans who work for them, invest in them, and benefit from all that they provide to our economy. We're re-orienting 404 to focus on what truly matters to investors – and away from expensive and unproductive make-work procedures that waste investors' money and distract attention from what's genuinely material. No longer will the 404 process tolerate procedures performed solely so someone can claim he considered every conceivable possibility.

These past few weeks have witnessed several positive steps for small business at the SEC. Not only are we approaching the finish line in our work to rationalize and improve the 404 process for smaller companies, but also we're tackling several other issues of importance to our nation's small businesses. The most important of these is our initiative to broaden small business access to the U.S. capital markets.

In the last few weeks, the Commission has voted to propose six separate measures to modernize and improve capital raising for small business, and to simplify SEC reporting for small business. Many of these proposals would implement key recommendations made by the Commission's Advisory Committee on Smaller Public Companies. The small business improvements that the SEC has very recently proposed include:

- Giving small businesses access to the expedited "shelf" registration process for their own securities offerings, which previously was available only to big companies.

- Cutting paperwork for thousands of small businesses, by allowing them to raise capital in a private offering after filing a simplified Form D online.

- Establishing shortened holding periods for restricted securities, making it easier for small business shareholders to put their securities on the market sooner and hopefully reducing the discount that small businesses must absorb to sell restricted securities.

- Giving issuers the benefit of a new, limited offering exemption from Securities Act registration requirements for offerings and sales of securities to a newly defined category of "qualified purchasers" in which limited advertising would be permitted.

- Eliminating the limit on the number of employees who can receive stock options from their fast-growing private firms, improving the ability of emerging growth companies to attract and retain talent without prematurely triggering the requirements of the Exchange Act.

- Providing a simplified system of disclosure for almost 1,600 additional smaller public companies, an increase of over 45% in the number of small companies that are currently eligible.

This focus on capital formation and the removal of obstacles to the growth of small businesses is appropriate given the historic importance of small business in the United States as a driver of economic activity, innovation, and job creation. Our concerns for small business go hand in hand with our responsibility to protect investors. It is, after all, investors who are injured and whose money is lost when the small businesses in which they invest can't get affordable access to new capital.

Madam Chairwoman, the SEC takes equally seriously each element of its tripartite mission: investor protection, efficient markets, and healthy capital formation. The 404 reforms, the capital raising improvements, and the reporting simplifications we've proposed to benefit small business will, I am certain, help our country to accomplish all three of these objectives.

Thank you again for the opportunity to speak on behalf of the Commission. I would be happy to answer any questions that you may have.

PCAOB
Public Company Accounting Oversight Board

Mark W. Olson
Chairman
Public Company Accounting Oversight Board

Before the
Committee on Small Business

United States House of Representatives

June 5, 2007

Chairwoman Velazquez, Ranking Member Chabot, and Members of the Committee:

I am pleased to appear on behalf of the Public Company Accounting Oversight Board ("PCAOB" or the "Board") to speak about the impact of the Sarbanes-Oxley Act of 2002 (the "Act") on small business, and, in particular, the PCAOB's oversight of small audit firms and its auditing standard on internal control over financial reporting. I am also pleased to join Chairman Cox before you for today's hearing on "Sarbanes-Oxley Section 404: Will the SEC's and PCAOB's New Standards Lower Compliance Costs for Small Companies?" The PCAOB works closely with the Securities and Exchange Commission ("SEC") to achieve our shared goal of protecting the interests of the investing public in the preparation of informative, accurate and independent audit reports on public company financial statements.

I. Introduction and Background

This Committee's focus on small business, and its particular focus today on the impact of the Act's internal control provisions, are both appropriate and timely. Last month, the PCAOB replaced its auditing standard on internal control over financial reporting, which I will later describe in greater detail. A priority concern that triggered that action is the desire to assure that the audit mandated by the Act can be conducted in a manner consistent with the size and complexity of America's small publicly traded companies. The market will bear out how the new standard affects overall audit costs, but in revising its standard, the PCAOB has been committed to providing for a sound audit that gives auditors of small companies the flexibility they need to design and

perform cost-effective audits that are tailored to the unique attributes of small business while still achieving the important objectives of the audit.

Madam Chairwoman and Committee members, we see two important dimensions to the PCAOB focus on small business. First, of the 1,000 plus domestic audit firms that have registered with the PCAOB, the overwhelming majority are small firms. While our experience in inspecting these firms varies, we are reassured to discover that many very small firms provide high quality audits for their clients, many of whom are small businesses. The second dimension of our small business focus is our recognition that these small businesses constitute the largest segment of entities affected by our audit standards, and we need to be cognizant of their needs as we develop the standards.

With more than half of all American households invested in U.S. public companies,[1/] the discoveries of financial reporting and auditing improprieties at numerous public companies earlier this decade swelled in 2002 to a national crisis of confidence in the integrity and reliability of public companies' financial statements. Widespread investor risk aversion across markets adversely affected innovation and the economy more broadly.[2/] This led to a predictably strong response on the part of the

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1/ Due to the expansion of defined contribution plans and other incentives, nearly 57 million U.S. households own stocks directly or through mutual funds, according to a study by the Investment Company Institute and the Securities Industry Association. See *Equity Ownership in America: 2005* (November 2005), *available at* http://www.ici.org/pdf/rpt_05_equity_owners.pdf.

2/ By all measures, the forward risk premium for the S&P 500 swelled in October 2002 to nearly double the historical mean. The forward risk premium reflects the additional risk that investors perceive exists in the stock market, as compared to the bond market. See Monthly Earnings Report, Lehman Brothers, at 72 (April 7, 2004). The effect of this risk aversion was not limited to U.S. markets. For

investing public, as well as public company boards, the accounting profession, regulators, and Congress. There was an increased recognition of the need to bolster controls over financial reporting and bring an enhanced focus to corporate governance. Congress reacted by passing the Act, which among other things established the PCAOB to replace the accounting profession's self-regulatory model with an independent oversight system.

The PCAOB's mandate is to oversee the auditors of public companies, in order to protect the interests of the investing public in the preparation of informative, accurate and independent audit reports on public company financial statements. The PCAOB does not set accounting standards or regulate disclosures by public companies; rather, its role is to improve the quality and reliability of public company audits, so that investors can have more confidence in audited financial statements. High quality financial disclosure by public companies is a cornerstone of U.S. capital markets and is necessary for the continued growth and competitiveness of the U.S. economy.

With that brief history as context, I would like to devote my time today to describing the PCAOB's programs, with a particular focus on the PCAOB's approach to small audit firms. In addition, I will describe the PCAOB's efforts, together with the SEC, to implement the provisions of the Act related to internal control, again with a

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example, in 2002 it led to the collapse of Germany's Neuer Markt, a young stock market designed to provide capital opportunities for small European companies and thus to compete with U.S. markets for shares of new "dotcoms" and other technology companies. See Benoit, B., Skorecki, A., and Stafford, P., "Deutsche Borse to Close Neuer Markt Next Year," Financial Times (September 27, 2002).

particular focus on preparations for small companies and their auditors to implement those provisions, according to the timetable established by the SEC.

II. The PCAOB's Auditor Oversight Programs Foster a Dialogue with Small Audit Firms to Help Them to Improve Their Audits and Compete in the Market to Provide Public Company Audit Services.

Subject to the oversight authority of the SEC, the Board is responsible for --

- Registering audit firms that prepare audit reports for U.S. public companies;
- Establishing, by rule, auditing and related professional practice standards relating to the preparation of audit reports for U.S. public companies;
- Conducting inspections of registered firms;
- Conducting investigations of, and imposing appropriate sanctions where justified upon, registered firms and associated persons of such firms.

I will focus my remarks today on the PCAOB's oversight and interaction with, small firms in particular.

A. More Than 1,700 Accounting Firms Have Registered with the PCAOB.

Early concerns that independent oversight might deter firms, particularly smaller firms, from continuing to audit public companies have not borne out. On the contrary, since the PCAOB opened its doors in January 2003, it has registered more than 1,700 accounting firms that audit, or wish to audit, U.S. public companies. Of these firms, about 1,000 are U.S. firms. The firms vary dramatically in size. Some are multi-office regional firms with several, and sometimes a great number of, partners and professional staff, and others are sole practitioners with no professional staff. Only about 150 of these firms had more than five public company clients at the time they registered. In

addition, more than 450 of these firms registered even though they were not the auditor of record for a public company at the time they registered.[3/]

The PCAOB has observed that the market is improving for small audit firms registered to audit U.S. public companies. The Big Four firms have reduced their public company audit client base by more than 1,000 clients since Arthur Andersen's demise. In the same period, the next four and even smaller firms have increased the number of public companies that they audit: the next four have added more than 250 audit clients among them, and smaller firms have taken on more than 580 audit clients.[4/] Indeed, within the last year, two registered firms have grown their audit practices to such an extent that they now issue audit reports for more than 100 public companies, which triggers the requirement under the Act and the Board's rules that the Board conduct annual inspections of those firms. Ten U.S. firms and one non-U.S. firm are now subject to annual inspection.

Smaller firms are likely to continue to seize opportunities to expand their businesses by taking on new clients appropriate to the size and sophistication of the firms' practices. At the same time, for their business growth to reach its full potential,

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3/ Importantly, the PCAOB's rules related to registration were designed with care not to impose unnecessary impediments for small firms. Thus, while a registering firm must demonstrate that the Board's approval of its application is consistent with the Board's responsibilities under the Act to protect the interests of investors and to further the public interest in the preparation of informative, accurate, and independent audit reports, firms need not have a current public company audit client in order to register.

4/ See Yellow Card Trend Alert, Glass, Lewis & Co., at 5 (May 21, 2007). According to this study by Glass, Lewis & Co., since Arthur Andersen's demise, Big Four firms reduced their public company audit clients by 1,030, the next four firms added overall, net, 266 public company audit clients, and smaller firms realized a net gain of 588 public company audit clients.

the firms must understand and know what is expected of them within the Sarbanes-Oxley and PCAOB framework. For smaller firms, the adjustment to that framework can give rise to issues and questions different from those for the larger firms.

B. The PCAOB Uses Outreach to Small Firms and the Small Business Community to Provide Information About PCAOB Activities and Seek Insight on Small Business Concerns and Challenges.

The PCAOB has established an ambitious outreach effort directed toward small registered firms and their audit clients to address their unique issues and questions. These one- and two-day discussion sessions, called Forums on Auditing in the Small Business Environment, follow an in-depth curriculum on PCAOB activities and developments. They have provided an avenue for small registered firms and small public companies to obtain a better understanding of the workings of the PCAOB, and they have fostered a robust dialogue that has given the PCAOB valuable insights to apply in its programs. In addition, I believe the Forums have better equipped firms with information to address the challenges of the regulatory environment.

To date, the PCAOB has held 21 Forums in 14 metropolitan areas across the country. Nearly 2,000 people involved in the small business community have attended the Forums, including about 1,500 auditors from smaller public accounting firms. Based on positive feedback from participants, the PCAOB intends to continue to hold Forums to further the PCAOB's dialogue with such firms and companies.

C. The PCAOB's Supervisory Inspection Program Helps Small Firms Focus on Audit Quality Necessary to Compete in the Market to Provide Public Company Audit Services.

While the Forums reach small firm auditors in a group environment, PCAOB inspections foster an even deeper, one-on-one dialogue between the PCAOB and small registered firms. Under the Act and the Board's rules, firms that audit the financial statements of 100 or fewer public companies are subject to inspection at least once every three years. The PCAOB has taken a supervisory approach toward implementing its inspection program. In these inspections, the PCAOB has observed first-hand how some small firms distinguish themselves professionally and competitively by performing high-quality audits. In other cases, PCAOB inspections identify areas in which firms should do better. For those firms that strive to improve the quality of their audits and their ability to compete for public company audit clients, the supervisory dialogue throughout the inspection process helps them to do so.

While the PCAOB's inspections are the core of its supervision of registered firms, these inspections take place largely outside the public view. This is because the Act mandates a significant degree of confidentiality relating to inspection information. One particular provision relates to any portion of a PCAOB inspection report that describes criticisms of the firm's system of quality control. Under the Act, a firm has one year to show that it has satisfactorily addressed those criticisms, and if it does so those criticisms remain nonpublic. This remediation mechanism reflects Congress's policy decision to use the possibility of public disclosure as an incentive to firms to address

systemic problems.[5/] It has proven to be a key tool to motivate firms to do better. When the PCAOB identifies problems, firms typically take those criticisms seriously and make substantial changes within a year.

Under the Board's supervisory approach, it is able to use its inspection process to address most of the individual, or isolated, auditing problems identified, without the need to invoke its disciplinary authority to enforce applicable laws and standards. For example, when an individual audit is not up-to-grade, inspectors discuss with the firm precisely what the deficiency is. Sometimes this means a firm will perform additional audit procedures to shore up a weak audit. When the problem relates to an individual auditor, a firm may provide additional training to or supervision of the person involved or take other action the firm determines is appropriate. Thus, the PCAOB inspection process has been able to prompt and facilitate firms' achievement of significant real-time improvements, often even before an inspection is concluded.

D. The PCAOB Develops Auditing and Related Professional Practice Standards with the Needs and Challenges of Small Firms in Mind.

The Act directs the Board to establish certain standards for use by auditors of public companies. Those include standards for auditing and related attestation work, standards for quality controls, ethics standards, and independence standards. In order

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5/ In order to give the public an understanding of how this incentive works, last year the Board described its experiences in monitoring firms' efforts to address problems identified in the first year of inspections. *See* PCAOB Release No. 104-2006-078, Observations on the Initial Implementation of the Process for Addressing Quality Control Criticisms within 12 Months After an Inspection Report, March 21, 2006, available at http://www.pcaobus.org/Inspections/ Public_Reports/2003/2006-03-21_Release_104-2006-078.pdf; *see also* PCAOB Release No. 104-2006-077, The Process for Board Determinations Regarding Firms' Efforts to Address Quality Control Criticisms in Inspection Reports, March 21, 2006, available at http://www.pcaobus.org/Inspections/2006-03-21_Release_104-2006-077.pdf.

to ease firms' transition to independent oversight, early in the Board's first year of operation, in 2003, the Board adopted as interim standards certain auditing and related professional practice standards that had been developed and adopted by the auditing profession prior to the establishment of the PCAOB. These are standards with which audit firms large and small were already familiar, as they existed on April 16, 2003.[6]

Since adopting this body of pre-existing standards, the Board has adopted five new standards[7] as well as new ethics and independence rules relating to tax services and contingent fees. To develop new standards and rules, the Board uses a standards-setting process that provides for public input at a variety of stages. In particular, three times a year the Board holds a public meeting with its Standing Advisory Group.[8] The advisory group's 31 members are drawn from a cross-section of the nation's companies – small and large – as well as auditors from small and large accounting firms, investors and their advisors, academics, and others. These individuals share their informed

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[6] In summary, these are: Generally Accepted Auditing Standards (or, "GAAS") as previously established by the American Institute of CPAs ("AICPA"); Attestation Standards and related interpretations and Statements of Position as previously adopted by the AICPA; the AICPA's Statements on Quality Control Standards and certain AICPA SEC Practice Section membership requirements; certain provisions of the AICPA's Code of Professional Conduct on integrity and objectivity, and the standards and interpretations of the Independence Standards Board.

[7] Specifically, the Board's Auditing Standard No. 1 relates to references in auditors' reports to the standards of the PCAOB; Auditing Standard No. 2 (and Auditing Standard No. 5, which replaces it) relates to audits of internal control over financial reporting; Auditing Standard No. 3 relates to audit documentation, and Audit Standard No. 4 relates to auditors' reporting on whether a previously reported material weakness continues to exist. They are available on the Board's Web site at http://www.pcaobus.org/Standards/Standards_and_Related_Rules/ index.aspx, along with the Board's new ethics and independence rules.

[8] The Board convened its Standing Advisory Group pursuant to Section 103(a)(4) of the Act. The Group consists of experts in auditing and financial reporting, including individuals with experience at institutional investors, accounting firms, and public companies.

opinions on how the Board, consistent with its mandate, can improve the quality of audits, including by advising on best practices and emerging issues. Many of the advisory group's discussions have focused on matters related to small business and the audits of small registered firms. On occasion, they have also included dedicated panels of small firm auditors who can offer their insights on best practices and their experiences with the unique challenges the small business community faces.[9/]

In addition to seeking the views of its advisory group members and other interested persons, the Board seeks public comment on proposed new standards and rules, makes those comments publicly available on its Web site, and considers them before adopting final standards or rules. Board standards are also subject to SEC review, and they do not go into effect unless they are approved by the SEC.[10/]

III. The PCAOB's Role in the Act's Internal Control Requirements

I would like to devote the remainder of my time today to the PCAOB's role in implementing, through its auditing standards, the provisions of the Act related to internal control over financial reporting. In particular, Section 404 of the Act requires public companies annually to provide investors an assessment of their internal control over financial reporting, accompanied by an auditor's attestation on the same subject.

9/ The Board also participates as an observer of other agencies' initiatives to examine issues germane to the small business community, including the SEC's Advisory Committee on Smaller Public Companies, the Committee of Sponsoring Organization's Task Force on Guidance for Smaller Public Companies, and the Financial Accounting Standards Board's Small Business Advisory Committee.

10/ In most cases, applicable securities laws and rules provide for the SEC to publish PCAOB rules and standards for public comment as part of the SEC's consideration and approval process.

A. The Act's Internal Control Reporting and Auditing Requirements

The term "internal control over financial reporting" refers to a company's system of checks and processes designed to protect corporate assets, keep accurate records of those assets as well as its financial transactions and events, and prepare accurate periodic financial statements. Investors can have much more confidence in the reliability of a company's financial statements if management demonstrates that it maintains adequate internal control over bookkeeping, the sufficiency of books and records for the preparation of accurate financial statements, adherence to rules about the use of company assets, and the safeguarding of company assets. Indeed, research shows that disclosures about the reliability of internal control have a significant effect on companies' cost of capital.[11/]

Companies have been required to have internal control over their accounting since Congress enacted the Foreign Corrupt Practices Act in 1977. There is no doubt, however, that the Sarbanes-Oxley Act's requirement for annual assessments, and auditor attestations to those assessments, intensified scrutiny of companies' internal control over financial reporting.

As directed by Section 404(a) of the Act, in June 2003 the SEC established rules describing companies' required assessments. In March 2004, the PCAOB implemented

[11/] See Ashbaugh-Skaife, Collins, Kinney and LaFond, The Effect of Internal Control Deficiencies on Firm Risk and Cost of Equity Capital (April 2006, updated February 2007). Specifically, the researchers found that when companies report they have corrected a previously reported material weakness in internal control, their cost of capital goes down on average 1.5 percent. Conversely, when companies report material weaknesses in audited financial reports after they had previously reported in unaudited statements that internal control was effective, their cost of capital goes up on average almost 1 percent (93 basis points).

Sections 103, requiring an auditing standard on internal control, and 404(b) of the Act by establishing a new auditing standard – Auditing Standard No. 2 – to provide for an audit of internal control over financial reporting integrated with the audit of the financial statements themselves. The SEC approved Auditing Standard No. 2 in June 2004.[12/] For large, established companies – which the SEC calls accelerated filers – the initial assessments and attestations were required by SEC regulations to be included in their annual Form 10-K filings for fiscal years ending after November 14, 2004.[13/]

The SEC has delayed implementation for smaller companies, i.e., non-accelerated filers. Such companies have until they file financial statements for a fiscal year ending on or after December 15, 2007, to file their first management assessments of internal control. In addition, the SEC will not require such companies to file audit reports on such assessments until they file financial statements for a fiscal year ending on or after December 15, 2008.[14/]

12/ See SEC Release No. 34-49884, Order Approving Proposed Auditing Standard No. 2, An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements (June 17, 2004).

13/ Accelerated filers (and large accelerated filers) generally include companies with an aggregate market value of voting and non-voting common equity held by non-affiliates of the issuer (referred to as "public float") of $ 75 million or more, as of the last business day of the issuer's most recently completed second fiscal quarter. See SEC Exchange Act Rule 12b-2, 17 C.F.R. 240.12b-2; see also SEC Release 33-8644, Revisions to Accelerated Filer Definition and Accelerated Deadlines for Filing Period Reports (December 21, 2005) (amending definition of "accelerated filer" to distinguish between "accelerated filers" and "large accelerated filers," which have a public float of $700 million or more). According to the SEC, approximately 44% of domestic companies filing periodic reports are non-accelerated filers. See SEC Release No. 33-8760, Internal Control over Financial Reporting in Exchange Act Periodic Reports of Non-accelerated Filers and Newly Public Companies (December 15, 2006), at 11.

14/ See SEC Release No. 33-8760, Internal Control over Financial Reporting in Exchange Act Periodic Reports of Non-accelerated Filers and Newly Public Companies (December 15, 2006).

B. Although the Act's Internal Control Reporting Requirements are Not Yet Applicable to Small Companies, the PCAOB Has Used Its Experience Monitoring Large and Mid-Cap Company Implementation to Revise Its Auditing Standard and Develop Tailored Guidance with Small Companies In Mind.

Notwithstanding this delay, there is considerable concern among small public companies about implementing the Act's internal control reporting requirements. For its part, the PCAOB has monitored implementation by companies that are subject to the requirements, among other things with a view toward easing implementation challenges smaller companies may face. To this end, based on that experience, the PCAOB recently revised its auditing standard on internal control and is developing specialized guidance and training for auditors of small companies.

1. The PCAOB Has Monitored Auditors' Implementation of Auditing Standard No. 2 and, as Needed, Provided Guidance.

In the nearly three years since the SEC's rule on management assessments of internal control and the Board's related auditing standard went into effect for accelerated filers, the Board has closely monitored the challenges that those companies and their auditors have faced. As appropriate, the PCAOB has provided additional guidance to facilitate implementation. In this regard, the Board's staff issued five sets of interpretive guidance that answer 55 frequently asked technical questions on the implementation of Auditing Standard No. 2.[15/] In addition, on May 16, 2005, the Board

[15/] These questions and answers are available at http://www.pcaobus.org/Standards/Standards_and_Related_Rules/Auditing_Standard_No.2.aspx.

issued a policy statement describing ways auditors can make their internal control audits as effective and efficient as possible.[16]

The PCAOB has also used its inspections of larger firms to monitor firms' implementation of the Board's auditing standard on internal control. To this end, the PCAOB has issued two reports on its inspections and other monitoring, on November 30, 2005, and April 17, 2007. Those reports describe best practices observed in the first and second years, respectively, as well as providing additional guidance on how auditors can make their work more efficient.[17]

The PCAOB's monitoring has also included participating, along with the SEC, in two roundtable discussions with representatives of public companies, auditors, investor groups, and others; meeting with its Standing Advisory Group; receiving feedback from participants in the Board's Forums on Auditing in the Small Business Environment; and reviewing academic, government, and other reports and studies, including the Government Accountability Office's April 2006 report on Sarbanes-Oxley Act: Consideration of Key Principles Needed in Addressing Implementation for Smaller

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[16] See PCAOB Release No. 2005-009, Policy Statement Regarding Implementation of Auditing Standard No. 2 (May 16, 2005).

[17] See PCAOB Release No. 2005-023, Report on the Initial Implementation of Auditing Standard No. 2 (November 30, 2005), available at http://www.pcaobus.org/Rules/Docket_014/2005-11-30_Release_2005-023.pdf; PCAOB Release No. 2007-004, Report on the Second-year Implementation of Auditing Standard No. 2 (April 18, 2007), available at http://www.pcaobus.org/Inspections/Other/2007/04-18_Release_2007-004.pdf. Importantly, in the first of those reports, issued after the first year of implementation, the Board found that many auditors faced tight deadlines, staffing and other resource constraints, and significant training needs. Moreover, their clients faced similar hurdles that were, in many cases, exacerbated by having to make up for deferred maintenance on internal control systems that had not kept up with the company's growth and development.

Public Companies, and the Final Report of the SEC's Advisory Committee on Smaller Public Companies issued the same month.[18]

2. The Board Has Revised Its Standard, to Promote Efficiency and Eliminate Unnecessary Procedures.

The Board is determined to make internal control audits as cost-effective as possible for companies that are required by the SEC's rules to obtain an audit report on internal control. Therefore, based on its experience monitoring implementation, on December 19, 2006, the Board proposed a revision of its auditing standard on internal control, along with related amendments and rules. The Board received 175 comment letters on the proposal. After considering these comments, as well as the input provided by the SEC at an Open Meeting on April 4, 2007, the Board adopted a new auditing standard – Auditing Standard No. 5 – on May 24, 2007. If approved by the SEC, the new standard will replace Auditing Standard No. 2 in its entirety.[19/]

One of the primary goals of the new standard is to provide explicit guidance on scaling audits to reflect the attributes of smaller, less complex companies. In addition, the new standard has three other objectives. Specifically, the new standard –

- **Focuses the audit on the matters most important to internal control** – The new standard focuses auditors on those areas that present the greatest risk that a company's internal control will fail to prevent or detect a material misstatement in the financial statements. It does so by

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18 See GAO, Sarbanes-Oxley Act: Consideration of Key Principles Needed in Addressing Implementation for Smaller Public Companies (April 2006, GAO-06-361); Final Report of the Advisory Committee on Smaller Public Companies (April 23, 2006), available at http://www.sec.gov/info/smallbus/acspc/acspc-finalreport.pdf.

19/ On May 23, the SEC adopted guidance that can be used by management in making the assessment required by Section 404(a) of the Act. See SEC Release No. 33-8762, Management's Report on Internal Control Over Financial Reporting (December 20, 2006).

incorporating certain best practices designed to focus the scope of the audit on identifying material weaknesses in internal control, before they result in material misstatements of financial statements, such as using a top-down approach to planning the audit. It also emphasizes the importance of auditing higher risk areas, such as the financial statement close process and controls designed to prevent fraud by management. At the same time, it provides auditors a range of alternatives for addressing lower risk areas, such as by more clearly demonstrating how to calibrate the nature, timing and extent of testing based on risk, as well as how to incorporate knowledge accumulated in previous years' audits into the auditors' assessment of risk and use the work performed by companies' own personnel, when appropriate.

- **Eliminates unnecessary procedures** – The Board examined every area of the internal control audit to determine whether the previous standard encouraged auditors to perform procedures that are not necessary to achieve the intended benefits of the audit. As a result, among other things, the new standard does not include the previous standard's detailed requirements to evaluate management's own evaluation process and clarifies that an internal control audit does not require an opinion on the adequacy of management's process.

- **Simplifies the requirements** – The Board's new standard is shorter and easier to read. This is in part because it uses simpler terms to describe procedures and definitions. It is also because the standard has been streamlined and reorganized.

These steps are designed to provide for a sound audit that gives auditors of small companies the flexibility they need to design and perform cost-effective audits that are tailored to the unique attributes of small business.

3. The Board Plans Guidance for Auditors of Small Companies.

In 2006, even before the Board revised its auditing standard, it embarked on an initiative to develop tailored implementation guidance for audits of small companies, based on the experience and insights of small companies and auditors who have been and are currently going through the process of evaluating internal control as well as the

Board's inspection and other monitoring experience. The guidance is intended to emphasize the scalability of internal control audits at a practical level, by providing auditors with examples of how the internal control audit process can and should be scaled to fit the relative sizes of small companies, from those that are on the cusp of accelerated filer status to those that have merely a handful of employees.

This initiative has progressed on a parallel track to the revision of the Board's auditing standard. Thus, beginning in January 2007, the PCAOB's focus group of auditors and small companies began evaluating an early prototype of the planned guidance, based on the Board's December 2006 proposal. The Board continues to develop this guidance in consultation with its focus group. The guidance will also be updated it in light of changes reflected in the standard as adopted. The PCAOB is targeting publication of the guidance later this year.

Finally, the Board is exploring various means of facilitating training for auditors of smaller public companies on auditing internal control. With constructive, practical guidance, the Board hopes that small companies and their investors will be able to reap the benefits of internal control reporting without unnecessary costs.

IV. Conclusion

The PCAOB works hard to achieve the objectives Congress set for it in the Act. The oversight program it has in place is reducing the risk of financial reporting failures and renewing confidence in the financial reports of public companies and, ultimately, in the U.S. securities markets. The Board continues to assess its oversight programs,

however, and in doing so it takes into account the effect on, and perspective of, the small business community. As I have described, the Board has and will continue to make appropriate adjustments to assure that it achieves the objectives of the Act in the most effective and efficient manner possible. In particular, the Board is committed to ensuring that its standard on internal control lays the foundation for efficient audits that are cost-effective for small business and maintain the benefits intended by the Act.

Thank you. I will be pleased to answer any questions.

BIO
BIOTECHNOLOGY
INDUSTRY ORGANIZATION

James C. Greenwood
President & CEO

Written Testimony

The Honorable James C. Greenwood
President and CEO
Biotechnology Industry Organization (BIO)

Before the Committee on Small Business
United States House of Representatives

Hearing on
"Sarbanes-Oxley Section 404: Will the SEC's and PCAOB's New Standards Lower Compliance Costs for Small Companies?"
June 5, 2007

Chairman Velazquez, Ranking Member Chabot and members of the Committee. Thank you for providing the opportunity to testify before you today on reforms to the Sarbanes-Oxley Act (SOX) Section 404 adopted by the Securities and Exchange Commission and Public Company Accounting Oversight Board.

I am Jim Greenwood, President and CEO of the Biotechnology Industry Organization (BIO). I am privileged to be here today on behalf of BIO, an organization representing more than 1,100 biotechnology companies, academic institutions, state biotechnology centers and related organizations in 50 U.S. states and 31 other nations. BIO members are involved in the research and development of health care, agricultural, industrial, and environmental biotechnology products. The majority of BIO member companies are small, research and development oriented companies pursuing innovations that have the potential to improve human health, expand our food supply, and provide new sources of energy. The promise of biotechnology is immense, as our members combine biology and technology to deliver new treatments for unmet medical needs, improved crops that are more drought resistant and have reduced environmental impact, and create cheaper, more environmentally friendly fuels and consumer products. Biotech is one of the most innovative high growth sectors of our nation's economy, and one in which the United States maintains a global leadership position.

At the outset, let me mention that BIO appreciates the Committee's efforts and vigilance regarding the implementation of Sarbanes Oxley Section 404. Also, my testimony today has greater specificity with respect to the PCAOB rules than it does the final rule approved by the SEC, as the SEC's rule is not yet available for public viewing. I note that it is surprising that in this day and age it is not possible for a major Federal agency to make the text of the rule it has formally approved available on the same day in which it takes action.

First, I'd like to start by providing a short answer to the Committee's question, posed in the title of this hearing, as to whether or not the SEC's and PCAOB's new standards will

lower compliance costs for small companies. In summary, the answer is a marginal "yes."

There has been considerable rhetoric from both the SEC and PCAOB that has accompanied these rules, and we appreciate the recognition of the many problems caused by the poor implementation of Sarbanes Oxley Section 404. The changes promulgated by the two agencies are well-intended, though they appear modest in effect. Ultimately, the rhetorical promises offered can only be kept if there is an on-going, consistent effort and commitment to reducing unneeded audit and compliance costs.

BIO fully appreciates and agrees with the Congressional intent behind Section 404 – to enhance investor protection and confidence. BIO members strongly support this goal. As this Committee well knows, though, where Section 404 has gone awry is in the implementation. The situation that many emerging biotech companies face is that funds that would be otherwise spent for core research and development of new therapies for patients are instead used for overly complex controls or unnecessary evaluation of controls. This legislation – for which I was a conferee in 2002 – was not intended to be a windfall for auditors, nor pile on the compliance costs for companies. As we all know, that was not our desire when we wrote this law. Indeed, the Senate Banking Committee report on the legislation specifically stated that with respect to Section 404, "the Committee does not intend that the auditor's evaluation be the subject of a separate investigation or the basis for increased fees." [1]

However, the scale of the problems that Section 404 has created suggests that Congress should closely monitor the implementation of these revisions to ensure that its original intent is achieved. It is critical to ensure that these new rules provide the greatest possible flexibility and scalability for small public companies.

<u>Consequences of One-Size-Fits-All Approach to the Industry and U.S. Competitiveness</u>

The one size fits all approach originally implemented by the PCAOB in its Auditing Standard #2 (AS-2) created checklist mentality to audits that increased both financial and manpower costs without appreciably improving financial reports or internal controls. These costs have been recognized, and documented last year, by the SEC Advisory Committee for Smaller Public Companies (Advisory Committee), which found that, "with more limited resources, fewer internal personnel and less revenue with which to offset both implementation costs and the disproportionate fixed costs of Section 404 compliance, [small] companies have been disproportionately subject to the burdens associated with Section 404 compliance."[2]

In addition, the U.S. Government Accountability Office issued a significant study last April that found that many small businesses had seen audit costs jump significantly, due

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[1] S. Rep. No. 107-205 at 31 (2002).

[2] Final Report of the Advisory Committee on Smaller Public Companies. April 2006. Page 23.

in large part to the implementation, rather than the compliance with the intent, of Section 404.[3]

For most biotechnology companies, the actual costs of Section 404 compliance, including both internal costs as well as external auditor costs, are substantial. In fact, the opportunity costs of Section 404 for smaller companies can be even greater, impeding the ability to invest in and sometimes, to continue ongoing, critical research and development activities. Another member company's experience shows the opportunity costs of Section 404 compliance. This company not only spent approximately $500,000 on its external attestation of internal controls but also had to endure additional costs in terms of (i) the reassignment of laboratory research personnel to perform internal control work dictated by AS-2 and the company's external auditors, (ii) the postponement of the hiring of 5-10 additional researchers, and (iii) the delay of promising R&D programs. Such diversion of resources away from research activities can delay critical product development and has, in turn, a detrimental effect on a company's ability to raise capital.
Biotech companies are at the forefront of developing new treatments for many diseases, and biotech companies presently are engaged in over 350 clinical trials for over 200 diseases, from cancer to multiple sclerosis.

Under the requirements of Section 404, significant time and money are spent to put in place complex systems and processes dictated by the AS-2and required by external auditors. Let me give one example as a reminder of manifest flaws of the current system: one of BIO's member companies had five employees working on Section 404 compliance at a cost of approximately $1 million per year. This company estimated that its controller spent approximately 35% of his time on Section 404, while the CFO spent approximately 20% of his time. To complete the mandated internal control processes and the "checklist" dictated by AS2, the company had to increase its accounting staff by 40%. Further, this company reports only a 7% decrease in costs in year two as compared to its first year of compliance.

It is also the experience of BIO members that the current problems with Section 404 are not merely growing pains where the costs and burdens will decrease once the auditors and companies become more familiar with the process and requirements. The current implementation of Section 404 imposes the same requirements, steps and reviews on all companies, by the same individuals year after year. As a result, the costs are fixed and ongoing, impacting the long-term investment resources of microcap and smallcap companies.

For the investors, their confidence and trust in public companies may have increased as a result of the passage of SOX as a whole and not necessarily due to Section 404. The other provisions in SOX include whistleblower protections, increased enforcement powers, auditor independence requirements and, perhaps most importantly, CEO and CFO certifications of company financial statements under section 302 of SOX. As we saw in

[3] U.S. General Accountability Office, "Sarbanes-Oxley Act: Consideration of Key Principles Needed in Addressing Implementation for Smaller Public Companies." April, 2006. GAO-06-361

the first and second years of Section 404 implementation, investors and the market generally had little market reaction when a company reported a "material weakness" in internal controls under Section 404. As discussed above, the costs of the implementation of Section 404, particularly for smaller public companies, appear to outweigh many of the benefits that are directly related to Section 404.

SEC and PCAOB's New Standards

Scaled Reform Needed for Smaller Public Companies

Both the SEC and PCAOB have taken steps to address the problems that have manifest from the implementation of Section 404. BIO commends both the SEC and PCAOB for taking to the steps to address the critical compliance problems that Section 404 audits had been creating, particularly for small and newly public companies. Both agencies suggest that these new requirements are to be "scaled", "risk-based" and "flexible". While the SEC's final guidance appears to provide a more flexible, principles-based set of rules for management, the new standards adopted by the PCAOB - while an improvement over the current standards – could still be improved to enhance flexibility, auditor judgment and consistency with SEC guidance. Furthermore, one could fairly say that in its revisions to its initial December 2006 draft, the PCAOB has taken a step back.

Removal of Small Company Definition – A Worrisome Signal?

Included in both the Commission's and the PCAOB's *proposals* were objective measures auditors could use in determining what is a "smaller company" – mainly, one with a market capitalization of less than $700 million and reported annual revenues of $250 million or less.[4] This was consistent with the recommendation of the Advisory Committee on Smaller Public Companies who suggested that an objective test – particularly a "revenue filter" - be used as a tool to define a smaller public company when scaling the audit.[5]

Unfortunately, this definition of a small company has been removed from the final PCAOB adopted rule. Ostensibly, this appears to have been done in order to encourage auditors to consider scaling the audit for the non-complex entities within large corporations. BIO certainly applauds that.

[4] See footnote 44 of SEC proposal. File No. S7-24-06. http://www.sec.gov/rules/proposed/2006/33-8762.pdf and Paragraph 9 of PCAOB proposal. Release No. 2006-007. http://www.pcaob.org/Rules/Docket_021/2006-12-19_Release_No._2006-007.pdf

[5] See page 15 of the Advisory Committee on Smaller Public Companies. http://www.sec.gov/info/smallbus/acspc/acspc-finalreport.pdf

But rather than maintaining the proposed objective definition of a smaller company and then expanding it to include the subjective criteria that could also be applied to parts of larger companies, the PCAOB removed the objective criteria altogether.

In other words, under the December proposal, the PCAOB had suggested no less than six indicators[6] that a company could receive audit treatment proportionate to a less complex company:

- Market cap of $700 million and annual revenues of $250 million [7]
- Few business lines;
- Less complex business processes and financial reporting systems;
- Centralized accounting functions;
- Extensive involvement by senior management in the day-to-day activities of the business; and,
- Few levels of management, each with a wide span of control

In dropping any reference to market capitalization or annual revenues, the PCAOB appears to have deleted the only objective criteria for scalability included in the rule incomplete it may have been. In doing so, the PCAOB seems to have changed the presumption that a company meeting those thresholds is a "small company" and thus subject to a less burdensome audit to a presumption that everyone is subject to the fullest, most comprehensive audit – unless, they, the auditor – determines otherwise, using the subjective criteria in the rule.

To its credit, the PCAOB nevertheless continues to use discuss smaller public company issues throughout the rule – at least thirteen times by our count. Yet it is a startling failure on PCAOB's part that it chose to no longer provide any definition of smaller company, while maintaining the subjective definition of less complex companies,

BIO is disappointed that the final rule by the PCAOB removed the only objective criteria it had. The lack of clear direction to auditors is one problem that could be solved by adoption of a bright line test in which smaller companies could be assured of the ability to avail themselves of the scaled, proportionate audit of internal controls.

Maintaining the market capitalization and revenue criteria would have alleviated concerns with the potential conflict of interest relating to the incentives of the auditor who is charged with evaluating the "size and complexity of a company in planning and performing the audit" and also being the company providing the work.[8] In pursuing its incentive to maximize profits, an auditor has an economic incentive to determine a company too large and too complex, thus requiring an extensive audit mandating additional hours of billing, etc.

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[6] See Paragraphs 9 and 10 of PCAOB proposal Release No. 2006-007 (pages A1-7 and A1-8)

[7] See footnote 6 of PCAOB proposal in which they also reference definition of smaller public company as having a market capitalization of $787.1 million as used by the SEC Advisory Committee on Smaller Public Companies , Release No 2006-007 (page A1-7)

[8] See page 28 of the proposal. Proposal-2006-00 http://www.pcaobus.org/Rules/Docket_021/2006-12-19_Release_No._2006-007.pdf.

In addition, some – like SEC Chief Accountant Conrad Hewitt as well as principals of the big accounting firms - have suggested auditors currently face unlimited exposure to legal liability and thus should receive some sort of limitation or cap on such liability.[9] While we make no policy judgment on that issue at this time, the mere consideration does suggest an auditor has great incentive to be overly ambitious with its internal control opinion in an effort to protect itself from such liability and the costs associated with litigation.

BIO would also note that auditors under PCAOB scrutiny tend to worry much more about being found deficient for having been too lenient with their audit clients rather than for being criticized for having been too rigorous or burdensome in their decisions. Accordingly, there is no incentive for an auditor to scale its audit because there are no penalties for being overly aggressive and creating unnecessary costs in an audit. The PCAOB should strongly consider how it evaluates auditors and examine how it could provide an incentive to be more efficient.

As result of this puzzling change, BIO believes that the new standards may do even less than the PCAOB's initial December 2006 initial revisions to counterbalance the incentives auditors face to be overzealous in their work. Consequently, while hoping for greater impact, it is unclear that the PCAOB's rules will lead to substantially lower audit fees or reduced burden on emerging biotech companies.

BIO believes a quantitative, objective standard for smaller public companies creates a much needed burden on the auditor to prove that a company falling within the pre-established thresholds has significant complexities that warrant a more detailed audit of the company's internal controls. Establishing quantitative measures relieves the PCAOB of the full burden of determining if auditors are in fact using their judgment to ensure shareholders, who ultimately carry the costs of the audit, are receiving value from a more complex audit.

It is BIO's view that by establishing quantitative measures as part of the consideration in scaling the audit, the auditor should look at a company within the established measures as a non-complex unit before their walkthrough. During the walkthrough, an auditor would be forced to seek reasons to increase the depth of the audit due to particular complexities of the company rather than look at all companies as a complex unit until proven otherwise by an auditor.

<u>Product Revenue: A Better Indicator of Complexity</u>

BIO has consistently advocated for scalability indicia that are most reflective of complexity. BIO supports the PCAOB's work to include the scalability criteria and guidance throughout the auditing standard. In order to achieve the benefits of the

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[9] See Taub, Stephen. CFO.com "SEC's Hewitt: Indemnify the Big Four," CFO.com, Stephen Taub 26 January 2007; and www.pwc.com, "Global Capital Markets and the Global Economy: A Vision from the CEOs of the International Audit Networks" November, 2006.

scalable approach, it is imperative that the auditors be encouraged to do so throughout the audit. Doing so minimizes the combined threat of litigation and PCAOB examination based upon terms and definitions that are mandatory and inflexible, and discourages auditors from using the maximum degree of checklist compliance.

BIO recognizes the efforts made by both the SEC and PCAOB to affirmatively attempt to reduce the audit and compliance burdens on all companies, specifically by focusing on the complexity of a company. However BIO believes by removing all objective measures established in the proposals, AS/5 has seen an "about-face" from the positive aspects the small business section of the proposal brought to the table.

As stated in our February 2007 comment letter, BIO believes that both the SEC and PCAOB should recognize product revenue as an important indicator of complexity in its own right. Rather than limiting auditor judgment by linking various attributes of smaller companies such as market capitalization and overall revenue, both agencies should be looking for ways to provide the indicia to auditors that operate both in conjunction and independently as proxies for complexity.

For these reasons, BIO does not see the real relief that our members need to support such an overarching rule.

<u>More Consistent Definitions</u>

At its April 4th, 2007 open meeting, the SEC authorized its staff to engage the PCAOB to improve the consistency of definitions in the 404 rules issued by both agencies. A multiplicity of standards and definitions that differ from those commonly employed in the area of financial reports themselves has contributed to the burdens associated with implementation of section 404.

BIO member companies had raised concerns that after changing auditors, they experienced new interpretations of "material weakness". Even within the context of a principles-based approach to auditing, some further clarification on this guidance was needed. We believe the clarification in the PCAOB adopted rule should accomplish this and laud the PCAOB for doing so.

BIO also commends the PCAOB for recognizing that its earlier standard – that an internal control deficiency had more than a "remote likelihood" of causing a misstatement was vague, confusing and resulted in unnecessary costs and audit burdens. BIO is pleased that both the SEC and PCAOB have adopted the same definitions of "materiality", "significant deficiency" and "material weakness".

<u>Use of the Work of Others in an Integrated Audit</u>

In our February 2007 comment letter, BIO urged the SEC and PCAOB to include in any reform of Section 404, that auditors be **required** to use the work of others such as management monitoring and testing that is done in accordance with SEC guidance.

BIO supports the PCAOB's work in agreeing to the use of one standard in evaluating the use of others work and by adopting a rule that allows auditors to use the work of others in the audit of internal controls over financial reporting as well as the integrated audit of financial statements. In addition, the PCAOB made progress in adopting a rule that allows for recognition of work of internal auditors, company personnel (other than internal auditors) and third parties working under the direction of management or the audit committee.

BIO does, however, remain concerned that the burden of determining the competency and objectivity of others work is placed solely on the shoulders of the auditor and leaves a great deal of subjective evaluation by the auditor in determining the competency and objectivity of others work. BIO believes that given the nature and structure of accounting firms, there remains no clear incentive for the auditor to recognize the work of others in conducting their audit of internal controls..

Use of Economic Cost-Benefit Studies

Lastly, BIO strongly believes that a rigorous economic study of the costs and benefits associated with implementation of Section 404 is imperative to understanding if the current reform proposals are meeting their objectives.

BIO would note here that the cost-benefit studies contained in the SEC proposal – and not even required in the PCAOB proposal – is wholly qualitative and lacks a quantitative analysis. Both agencies should be willing to engage in a true economic analysis of the cost and benefits associated with these proposals. Given the variety of other statutory requirements that both corporate management and outside auditors must comply with that pertain to the integrity of internal controls on financial reporting.[10] We commend SEC Commissioner Atkins in his questioning of the Commission's economic analysis and hope that he will continue to highlight this weakness during the Commission's consideration of AS/5.

Conclusion

BIO believes that these reforms are a marginal improvement over the current system of internal control audits but would note that the current system is so bad that any change is a marginal improvement. It is unclear, though not entirely likely, that these reforms will fully match the rhetoric surrounding their adoption. However, we remain hopeful that

[10] Section 13(b)(2)(B) of the Exchange Act requires, as it has since 1977, that public companies maintain a system of internal controls that provide reasonable assurances as to the accuracy of financial reports. This framework provides additional assurance to investors in a cost effective and risk based way to providing Section 404 relief for smaller public companies. Under SOX Section 302, each CEO and CFO must certify that the financial statements fairly present in all material respects the financial condition of the company, and they have disclosed all weaknesses in the internal controls which could be reasonably likely to adversely affect the company's ability to record, process, summarize and report financial information, among other items.

this is just the first of several steps both the PCAOB and the SEC will take to continue refining their rules and reducing the unnecessary burdens placed on America's emerging and innovative companies. In conjunction with their further improvement of the PCAOB's rule, we urge the SEC to provide an additional exception for non-accelerated filers.

The evidence appears clear as to the consequences of allowing the process to stall here: innovation may be stifled and U.S. competitiveness compromised. The stakes for getting this right could not be higher; BIO believes that both agencies have taken important steps to get on the right track – and now the final adoption of reform lies in the hands of the Commission which has the ability to make the much needed changes mentioned in our testimony today. Nevertheless, good intentions only go so far. Consistent oversight into the application of these new rules and consequent appreciation of how they are continuing to impact capital formation particularly for small companies will be critical to restoring the U.S. to its proper primacy in the global capital markets.

Thank you for your time and consideration of BIO's views. I would be happy to answer questions that the Committee may have

Testimony of

America's Community Bankers

on

"Sarbanes-Oxley Section 404: Will the SEC's and PCAOB's New Standards Lower Compliance Costs for Small Companies?"

before the

Committee on Small Business

of the

United States House of Representatives

On

June 5, 2007

Diane Casey-Landry
President and Chief Executive Officer
America's Community Bankers
Washington, DC

Chairwoman Velázquez, Ranking member Chabot, and Members of the Committee, I am Diane Casey-Landry, President and CEO of America's Community Bankers[1] (ACB). I am pleased to appear before you today to present our views on Section 404 of the Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley") and the compliance costs for small companies in the wake of recently approved standards by the Securities and Exchange Commission (SEC) and the Public Company Accounting and Oversight Board ("PCAOB"). ACB is a national trade association representing the nation's community banks of all charter types and sizes, including state and federally chartered savings institutions and commercial banks. ACB members pursue progressive, entrepreneurial and service-oriented strategies in providing financial services to benefit their customers and communities. Our members represent $1.7 trillion in assets across the nation and are both stock and mutually owned.

From the outset I would like to thank the Committee for your steadfast advocacy on behalf of small companies and for your efforts to provide relief from the burdens they encounter with Section 404 of Sarbanes-Oxley. ACB supports the regulatory relief provision in H.R. 1869, which would relieve community banks with up to $1 billion in assets from the costly internal control attestation and audit requirements of Sarbanes-Oxley. We also support H.R. 1508, introduced in the House Financial Services Committee by Representatives Greg Meeks (D-NY) and Tom Feeney (R-FL), which would create an exemption from Section 404 based on company size. Both of these measures take practical steps to clarify the intent and purpose of internal control assessments established in Sarbanes-Oxley.

[1] America's Community Bankers is the national trade association committed to shaping the future of banking by being the innovative industry leader strengthening the competitive position of community banks. To learn more about ACB, visit www.ACB.us.

ACB would also like to commend SEC Chairman Christopher Cox and PCAOB Chairman Mark Olson for the recent action taken by their respective agencies to address the burdens of Section 404 compliance for small companies. The recent interpretive guidance on internal controls approved by the SEC and new auditing standards approved by the PCAOB bring a principles-based approach to the evaluation and assessment of financial reporting and are important achievements that will address many of the burdens that have resulted from Section 404. Although it is too early to tell whether, or to what extent, the new rules will reduce the compliance costs for small public companies, we appreciate the initiative and leadership Chairmen Cox and Olson have demonstrated. While we had hoped for some additional flexibility, particularly in the area of the implementation deadline for non-accelerated filers, the SEC and PCAOB are headed in the right direction, and we look forward to working with them as they continue to identify a middle-ground solution to this complex issue.

Background

Sarbanes-Oxley was a well-intentioned law that was passed to strengthen public company corporate governance and financial disclosure in an effort to restore investor confidence in the public markets. We fully support adequate safeguards to protect the financial safety and soundness for all banks, both public and private. However, ACB has long been concerned that the unintended consequences of Section 404 requirements impose costs and other burdens on public companies of all sizes, without commensurate benefits to investors. This is particularly true with respect to smaller public companies. Moreover, community banks are part of a highly

regulated industry subject to alternative requirements, heightening the need for relief from the unnecessary and duplicative burdens they face.

Publicly held community banks are unique to all other public companies. Community banks are part of a highly regulated industry governed by numerous statutes and regulations covering almost every aspect of banking activity. Banks are subject to statutory and regulatory capital requirements, and each banking institution is regulated by two agencies: the agency that issued the bank's charter and the Federal Deposit Insurance Corporation ("FDIC"). In addition to banking laws and regulations, publicly traded banks also must comply with the SEC's recordkeeping and reporting requirements. No other publicly traded company is subject to the same scrutiny as a publicly traded bank.

Financial Disclosure and Governance for Banks

Even before Sarbanes-Oxley was signed into law, banks had 11 years of experience following a similar regulations designed to protect their safety and soundness. In fact, these regulations served as the initial model for Section 404. Consequently, upon enactment of Sarbanes-Oxley and the SEC's rules implementing Section 404, banks were faced with an additional burden of costs and a second layer of internal controls/financial reporting ("ICFR"). Section 36 of the Federal Deposit Insurance Corporation Improvement Act (FDICIA) of 1991[2] and Part 363[3] of the FDIC's regulations govern bank management's responsibility for financial statements and ICFR. Section 36 requires all banks to have annual financial statements prepared in accordance with generally accepted accounting principles (GAAP) and audited by an independent public

[2] 12 U.S.C. § 1831m
[3] 12 C.F.R. Part 363

accountant. The section also requires each bank to prepare annual management reports signed by the chief executive officer and the chief accounting or chief financial officer that contain a statement of management's responsibilities for 1) preparing the bank's annual financial statements; and 2) establishing and maintaining an adequate control structure and procedures for financial reporting, and for compliance with safety and soundness regulations. Bank management's report is required to be included in the annual report the bank files with the FDIC and its primary federal regulator. These annual reports are available to the public

For banks with over $1 billion in assets, these regulations also require the management to assess the effectiveness of its internal controls. In addition, for banks with over $1 billion in assets, the bank's independent public accountant must examine, attest to, and report separately on management's assertion concerning internal controls. The attestation report is also required to be included in the annual report the bank files with the FDIC or its primary regulator. The FDIC concluded that these thresholds would be consistent with the underlying statutory objectives of Section 36 of FDICIA, and ACB has consistently argued that similar thresholds should be sufficient for compliance under Section 404 of Sarbanes-Oxley.

Section 404 Compliance for Non-accelerated Filers

As stated earlier, ACB supports the efforts of the SEC and the PCAOB to improve the implementation of Section 404 of Sarbanes-Oxley, and we applaud the SEC for its recent Management's Guidance and the PCAOB for its revised auditing standard for internal control over financial reporting. However, we are disappointed that in approving the Management Guidance, the SEC decided against a further extension of the compliance dates for non-

accelerated filers despite requests for a delay from both this Committee as well as the Senate Committee on Small Business. Because of the new Management's Guidance and the significant revisions that were made to the auditing standard, ACB strongly believes that the Commission should further delay compliance with Section 404 for non-accelerated filers for a minimum of one year from the current deadlines.

Accelerated filers have had three years of experience with the implementation process and they are best able to incorporate the changes brought about by the Management's Guidance and the revised auditing standard. ACB's members that are non-accelerated filers are very much concerned with the cost and burdens of compliance. These smaller companies are acutely aware of the struggle accelerated filers underwent to implement Section 404, even though these larger companies have significantly more resources and economies of scale. Non-accelerated filers are the companies that can least afford to add personnel, consultants, and systems to comply with Section 404. This is particularly true if the Commission's proposed Management Guidance and the PCAOB's revised auditing standard prove unsuccessful in reducing the costs and other burdens associated with implementing Section 404. ACB appreciates the Chairwoman and Ranking Member's March 12, 2007 letter to SEC Chairman Cox voicing these same concerns, and with the filing deadline just 6 months away, we remain hopeful that additional consideration will be given to this important issue.

The Impact on National and Global Competitiveness

A broader and more deleterious consequence created by Section 404 is the attack on our nation's ability to compete. Strong financial markets are crucial to the health our nation's economy, and while ours are by far the strongest with regard to transparency and accountability, these safeguards are inadvertently creating a competitive marketplace advantage for Asia, the United Kingdom, and other markets in the European Union where regulatory scrutiny is far less severe and the legal system is not fraught with the same abuse and activism. Sarbanes-Oxley was created to increase waning investor confidence, and to create a more robust environment for foreign investment. But navigating the complexity of the United States' patchwork of regulatory burdens and fear of an increasingly frivolous litigious environment is driving more and more public companies -- and potential investors – overseas to seek regulatory shelter in a more streamlined environment. The situation is particularly grim from the standpoint of small companies. Generally, companies go public in order to raise capital through public markets. However, the Section 404 compliance costs have caused many companies to either remain or consider going private because the costs associated with being a public company outweigh the benefits.

Competitiveness concerns have an impact on our domestic economy as well. At a time when the outsourcing of jobs overseas is becoming more and more common among large corporations, small companies such as community banks continue to be job incubators on main street America. However, mergers and acquisitions involving community banks are typically motivated by real market pressures, including regulatory burden and unfair competition that is constricting community banks. For example, as of June 1, America's Community Bankers' NASDAQ index

("ACBQ")[4], is comprised of 517 banking companies with a combined market capitalization of $193 billion. At inception in December 2003, there were 542 companies with a market capitalization of $170 billion. Each year approximately 50 companies leave the index, primarily because of mergers, but also because of delistings. ACB estimates that as many as 20 percent of ACBQ's departures are because of a decision to delist, triggered primarily by efforts to reduce the burden created by Sarbanes-Oxley. Additionally, some of the mergers listed Sarbanes-Oxley burden as a contributing factor for the decision to merge, since Sarbanes-Oxley costs are proportionally higher for smaller companies. This does not take into account the missed opportunities for ACBQ since 2003, since the atmosphere for raising capital in the U.S. has gotten increasingly worse, particularly with regard to the cost of going public and the costs associated with compliance for a small public company in the United States.

We urge the SEC to update the Exchange Act's threshold for registration as a public company from the 500 shareholder level first imposed in 1964. The threshold should be moved to a much higher range in order to provide much-needed regulatory relief for smaller companies that choose to be public, but chose not to be listed on an exchange.

The policies embodied in Sarbanes-Oxley Section 404 have a trickle-down affect into the local economies as well, since community banks that decide to sell or merge with larger regional and national banking organizations will no longer have the presence in local communities beyond their branch offices. We all must work together to ensure that our community banks remain

[4] The America Community Bankers NASDAQ Index is the most broadly representative stock index for community banks. ACB and the NASDAQ Stock Market launched this Index in December 2003 to track the performance of the strong community-based banking sector.

community banks. Our customers – your constituents -- have come to depend on their local community banking institution to provide the best possible service. This comes from years of relationship-building and from living and working in the same communities. Part of achieving this goal is to reduce the amount of unnecessary regulatory burden that is hampering the ability of community banks to compete domestically.

Conclusion

On behalf of ACB and its member banks across the nation, thank you again for the opportunity to appear before you today. We appreciate the work this Committee is doing to ensure that small businesses continue to be engines of economic growth in the United States, and to mitigate some of the unnecessary and burdensome compliance requirements stemming from Section 404 of Sarbanes-Oxley. I would be pleased to answer any questions you may have.

U.S. House of Representatives
Small Business Committee

Sarbanes-Oxley 404: Will the SEC's and PCAOB's New Standards
Lower Compliance Costs for Small Companies?

Statement of Hal S. Scott
Nomura Professor of International Financial Systems, Harvard Law School
Director, Committee on Capital Markets Regulation
June 5, 2007

Chairwoman Velazquez, Ranking Member Chabot, and Members of the Committee. Thank you for giving me the opportunity to testify on this important issue on behalf of the Committee on Capital Markets Regulation ("CCMR").

The CCMR is independent and bipartisan, composed of twenty-three corporate and financial leaders drawn from the investor community, business, finance, law, accounting, and academia. The CCMR issued its Interim Report on the state of the U.S. public equity capital markets on November 30, 2006. The CCMR's purpose is to explore a range of issues related to maintaining and improving the competitiveness of U.S. capital markets.

The question posed by this Committee—will the new standards of the SEC and PCAOB lower Sarbanes-Oxley ("SOX") 404 compliance costs for small public companies—is crucial to the well-being of Main Street, the bedrock of the U.S. economy. The answer to your question about compliance cost reduction is simply that we do not know. Unfortunately, neither the PCAOB nor the SEC, at least based on what has been publicly released, has done any quantitative analysis of the cost reductions they expect to achieve through their new standards. Nor have they indicated that they would do field tests to determine achievable cost reduction before applying these revised standards to small companies.

My own guess is that costs will come down but only moderately because, even after a lengthy deliberative process, the agencies have failed to give enough precise guidance as to what internal controls management and auditors should look at—that is, what is "material." We should not, however be operating on guesses. Before we move full speed ahead on applying Section 404 to small companies we should have a much better idea of what the cost reduction will actually be.

As stated in our Interim Report, the CCMR believes that maximizing the competitiveness of U.S. capital markets is critical to ensuring economic growth, job creation, low cost of capital, innovation, entrepreneurship, and a strong tax base. The issue of the competitiveness of our capital markets is essentially an issue for Main Street, not Wall Street. Wall Street can move to

London, Main Street cannot. Indeed, Bloomberg news recently reported that so far this year investment banks have earned $1.1 billion in fees from European initial public offerings ("IPOs"), compared with only $1.4 billion from U.S. IPOs. In 2002, investment banks earned five times as much taking companies public in the United States as they did in Europe.

Our market is becoming less attractive to foreign companies. In the late 1990s, the U.S. exchange-listed capital markets were attracting forty-eight percent of the value of all global IPOs (where a company raises funds outside its home country). By 2006, the share of U.S. exchanges had fallen to 7.2 percent. Our market is also becoming unattractive to U.S. companies. In 2000, every IPO by a U.S. company took place in the United States; in 2006, 17 percent of the funds raised by U.S. companies in IPOs were raised abroad. And this is despite the fact that a U.S. company doing a public offering abroad is restricted from selling its stock to U.S. residents for a year. Both U.S. and foreign companies find the U.S. private market (that is, the Rule 144A market which is restricted to large institutions) more attractive than the public market. Straight public equity offerings on the three largest U.S. stock exchanges raised $154 billion last year, while 144A offerings raised $162 billion.

Our report also documents the tremendous growth in private equity capital and going-private transactions. One of the reasons for the increasing attractiveness of private equity markets is concern over the costs of going or remaining public. Between 2001-2006, the number of venture capital ("VC") backed acquisition exits with disclosed values has exceeded the number of VC-backed IPO exits by more than ten-to-one (1919 to 171), with a difference of value of $95 billion as compared to $12 billion (albeit that this comparison should be adjusted for the fact that IPO exits, unlike private exits, typically involve the sale of only a portion of the company).

Our Committee believes that the U.S. public markets are clearly becoming less attractive to companies, both foreign and domestic. While there are many factors responsible for this development, including better foreign markets and more capital available abroad, our Committee, as well as other studies, has concluded that the cost of U.S. regulation, as well as the prospect of class action lawsuits, has played a significant role. And one of the significant costs of regulation is the cost of SOX 404.

Our Committee believes that Section 404 has provided significant benefits to both investors and businesses by increasing the reliability of financial statements, strengthening internal controls, improving the efficiency of business operations, and helping to reduce the risk of fraud. The CCMR strongly supports the need for effective internal controls. However, the CCMR also believes that this objective can be achieved at a much lower overall cost than the average SOX implementation cost per company of $4.4 million in the first year, and $3.8 million and $2.9 million in the subsequent two years, as reported by Financial Executives International (FEI). Despite the reduction of costs, 78% of the 200 executives surveyed by FEI said the costs of SOX 404 still outweigh the benefits.

These cost estimates are only for direct costs, and ignore important indirect costs such as diversion of scarce management resources and time and the increased risk aversion of companies and boards. The burden for smaller companies is obviously greater than for larger companies

since costs are not generally proportionate to size. The costs under the present regime, particularly for small companies, remain very substantial.

Small companies that are already public may not be able to absorb such costs or remain solvent, let alone competitive. Indeed, they may be forced to exit the public markets to avoid such costs. More importantly, small companies in the future may find themselves starved for venture capital, and this could have a profound effect on the U.S. economy. Venture capitalists seek to exit their investments by going public—the dream of every start-up. According to the National Venture Capital Association, in 2006, venture-backed companies accounted for 10.4 million U.S. jobs or approximately 9 percent of total private sector employment, and $2.3 trillion in U.S. revenues, 17.6 percent of GDP. A majority of these venture-backed companies are now public. Less attractive public markets means less investment in small business.

As I have said, I expect that the new standards will bring down the costs of Section 404, but not as much as it could and should. This judgment must to some extent be tentative. While the PCAOB's proposal for a new Auditing Standard, AS5, is public, the SEC has yet to release the language of its own new standards, although it did provide some information in its release announcing changes (SEC Release 2007-101, May 23, 2007). I will assume the SEC standards are basically the same as set forth in its proposal of December 20, 2006 (SEC Release No. 33-8762), and consistent with the new proposal of the PCAOB.

Certain important improvements have been made that were called for by our Committee, We strongly support a top-down, risk-based approach that allows auditors and management to make use of their judgment in tailoring their evaluations of controls to the individual circumstances of the companies they audit, so-called "scalability." We also support the elimination of the requirement for an auditor to examine management's evaluation process. We further support the increased flexibility provided for auditors to rely upon the work of others and to limit the testing of low-risk controls. Auditors will be more able to adjust the nature, timing, and extent of their procedures based on knowledge obtained during previous audits, particularly as such knowledge impacts the auditor's assessment of risk. We also commend the PCAOB's focus on fraud controls. We applaud the work done by the agencies on these issues. We hope all of these measures will bring down costs for companies, including small companies. We just do not really know how much.

We also believe, however, that there are two serious defects in the SEC-PCAOB approach: failing to set a precise standard for materiality and deciding to apply the new standards to small companies before doing a thorough cost-benefit analysis of how these revised standards will affect small companies.

The question of materiality is at the heart of the SOX 404 problem. Management and auditors should only be looking at things that matter. The high costs of Section 404 are in significant part due to the fact that there is no clear guidance from either the PCAOB or SEC as to what does matter.

Under current guidance, a material weakness is defined as a significant deficiency, or a combination of significant deficiencies, that results in more than a remote likelihood that a

material misstatement of the annual or interim financial statements will not be prevented or detected. Materiality itself is determined by a broad range of qualitative considerations.

In the PCAOB's proposed AS5 (p. A7), a material weakness is defined as "a deficiency or a combination of deficiencies, in internal control over financial reporting, such that there is a 'reasonable possibility' that a material misstatement of the company's annual or interim financial statements will not be prevented or detected on a timely basis." The SEC used the same formulation of material weakness in the release announcing adoption of its new standards.

The change from "more than a remote likelihood" to a "reasonable possibility," if it is an improvement at all, is a minor one. Indeed, the PCAOB itself says in its proposal that "as a definitional matter, 'reasonable possibility' and 'more than remote' describe the same threshold...." More importantly, while companies and auditors are instructed to look at deficiencies which have a "reasonable possibility" of causing a material misstatement, they are given only very imprecise guidance as to what controls are material. The PCAOB guidance continues to provide a qualitative standard for materiality—the same qualitative standard it now uses for financial statements (Proposed A5, A-1, ¶19)—and the SEC appears to take the same approach.

There is no reason to examine internal controls that, even if deficient, could have no material impact on the financial statements of the company. Unfortunately, this appears to be happening today. As the CCMR's report shows (Figure V.3, p. 123), an analysis by Mercer Oliver Wyman of the 2006 GAO study indicates that between 2002-2005, fifty-three percent of restatements, using the same qualitative definition of materiality for internal control and financial statement weaknesses, had either a negligible negative (less than one percent) or a positive impact on company market value. The market clearly does not think most of these restatements involve truly material weaknesses.

Our Committee has recommended that materiality for internal control reviews should be defined consistently with the definition of materiality in financial reporting, as it is today, but that both definitions should be more precise. Specifically, the CCMR recommended that materiality for scoping an assessment should be defined, as it was traditionally, in terms of a five percent pre-tax income threshold. This standard would be consistent with the overall risk-based approach advocated by both the SEC and PCAOB. In cases where the five percent test would not be meaningful, the agencies should allow companies and their auditors to exercise their reasoned judgment in choosing other measures to evaluate materiality in ways that are relevant to investors. We are very concerned that without a presumptive quantitative standard, the costs of compliance with Section 404 will not be sufficiently reduced. There is no need to look at things that do not matter.

Our second concern is the decision announced by the SEC to apply its new management standards to financial statements filed in 2008 to both large and small companies, and the decision of the PCAOB to apply its new auditing standards to both types of companies with respect to financial statements filed in 2009. The CCMR recommended that the application of Section 404 to companies with less than $75 million of market capitalization should continue to be deferred until the standards were revised. This has been done. However, we also

recommended that after the revision of the standards, the SEC should reassess the costs and benefits of extending Section 404 to small companies. This could be done by field testing the new standards on large companies, as well as on small companies that voluntarily decided to adopt the new standards, and on the smallest of the companies already subject to Section 404, those between $75-$100 million in market capitalization. In-depth interviews could also be had with a sample of smaller companies and their auditors to assess the potential cost impact. Bear in mind that for small companies that have not yet been required to apply Section 404, the issue is how much the new standards will bring down first year costs, historically an average of $4.4 million.

To the extent that the SEC found that, even with the adopted reforms, the costs were still too high relative to the benefits, it should ask Congress to consider exempting small companies from the auditor attestation requirement of Section 404 while at the same changing the management certification requirement to one requiring reasonable belief in the adequacy of internal controls. Without the comfort of auditor attestation, management would not be able to make a stronger certification.

When the SEC implemented SOX 404 in 2003 it did so through a rule-making in which it estimated the costs of compliance with Section 404 would be $91,000 per company (SEC Release No. 33-8238, June 5, 2003). That estimate was, we now know, off by a factor of over 48. In reformulating AS5, the PCAOB has done no publicly available analysis of how much costs will be reduced by AS5 generally, or for small companies. The SEC in its proposed new rule changes and guidance (SEC Release No. 33-8762, December 20, 2006), provided only a cursory discussion of cost-benefit analysis with no quantitative estimates of cost.

The National Securities Market Improvements Act of 1996 requires the SEC to consider in any rulemaking process "in addition to the protection of investors, whether the action will promote efficiency, competition and capital formation." In *Chamber of Commerce of the United States v. SEC*, 412 F.3d 133 (D.C. Cir. 2005), the court struck down the SEC's proposed rule requiring that 75% of a mutual fund board be composed of independent directors and have an independent Chairman on the ground that the Commission provided insufficient analysis of the costs of its proposal. The court stated that "uncertainty may limit what the Commission can do, but it does not excuse the Commission from its statutory obligation to do what it can to apprise itself—and hence the public and the Congress—of the economic consequence of a proposed regulation before it decides whether to adopt the measure." Id., at 144. The Sarbanes-Oxley Act added an additional requirement for SOX rules, that the SEC "promulgate such rules and regulations, as may be necessary or appropriate in the public interest or for the protection of investors, and in furtherance of this Act." 15 U.S.C. §7202(a) (2007). These requirements would clearly apply to the rule-making portion of the new SEC standards. While it is less clear that such obligations extend to "guidance," the SEC still should have provided a cost-benefit analysis of its guidance as a matter of policy, particularly when the guidance involves the application of its own rules.

These cost-benefit obligations should be complied with ex ante, before the SEC adopts a rule, so that whatever analysis is done by the SEC is open to public scrutiny. Unfortunately, this

was not done. Further, we have no reason to believe that such analysis has even been done ex post, in the rule as adopted. We would hope the SEC would remedy this matter.

The SEC must still approve the new guidance of the PCAOB. This would appear to require an SEC rule-making procedure, with notice and comment. In addition, it may require the SEC to do a cost-benefit analysis since the SEC is approving a PCAOB rule. The law on this is not clear. However, the right policy is clear. Before allowing this new PCAOB standard to become operative, the SEC or the PCAOB should do a cost-benefit analysis with respect to PCAOB's revisions of its standards.

Everyone—companies, Congress, and the public—is entitled to know and comment on what cost reductions the two agencies expect to achieve consistent with investor protection, since this was a major objective of the exercise. We should not proceed on such an important matter without a more solid foundation.

What is the rush? The SEC has already deferred applying its rules to small companies four times, first in February 2004, and then in March 2005, September 2005, and December 2006. We think it would be prudent to continue to do so, until a rigorous cost-benefit analysis justifies applying the new rules to small companies. If the costs are still too high, the SEC should then turn the problem over to the Congress.

National Venture Capital Association

House Small Business Committee Hearing
June 5, 2007
"Sarbanes Oxley Section 404: Will the SEC and PCAOB's New Standards Lower Compliance Costs for Small Companies"

Testimony of:
Mark G. Heesen
President
National Venture Capital Association

Chairwoman Velazquez, Ranking Member Chabot and Members of the Committee, my name is Mark Heesen and I am president of the National Venture Capital Association (NVCA) which is based in Arlington, Virginia. The NVCA comprises more than 480 venture capital firms in the United States and advocates for policies and legislation that are favorable to entrepreneurship, capital formation and innovation.

I would like to thank the Committee for the opportunity to contribute to the discussion around Sarbanes Oxley reform measures. This has been an area of expressed concern for NVCA members and their venture backed entrepreneurs for a significant period of time and we are anxious for relief. Venture backed companies are a critical component of US economic growth. In 2006, companies that got their start with venture capital accounted for 10.5 million US jobs and 2.5 trillion dollars in revenues. That equates to 9 percent of the US private sector employment and 17 percent of US GDP. Companies that were once venture backed include Google, Genentech, Starbucks, FedEx, Intel, eBay and Microsoft. These companies were once small and privately held – waiting for the opportunity to go public. Today the next Microsoft is waiting -- but has yet to go public because SOX compliance has been too burdensome – and other alternatives are available.

As you are all aware, our primary concern with the Sarbanes Oxley law is that the cost and effort related to Section 404 has hindered the economic development of promising venture backed companies in the United States. We have both anecdotal and quantitative evidence that many of these companies have been held back from their ultimate goal of an initial public offering due to the high cost of 404 compliance and the lack of support from the accounting profession. In 2006 there were only 57 venture backed IPO's on US exchanges and 17 IPO's on foreign exchanges. Twenty three percent of US venture backed IPO's did not occur here in the US. Prior to SOX it was virtually unheard of for a US venture-backed company to go public anywhere else but a US exchange.

What is more concerning is that we are now seeing companies that have a high enough profit run rate to consider an IPO choosing to be acquired instead. They want to rid themselves of the SOX burden which currently remains for smaller public companies. The result is a long list of companies that should have been stand alone economic contributors being absorbed into larger entities. Rather than an IPO on a US exchange being the ultimate achievement for a venture backed company, it has now become, at best, one of many options to be considered and, at worst, an outcome that is actually avoided. Imagine if Google had been acquired by Microsoft, or Dell acquired by Compaq, or Genentech acquired by J&J. Perhaps the innovation would have survived but the market value, jobs and revenues would have been diluted substantially.

It has been more than two years since the first recognition that the SOX Section 404 is harmful to small companies. We commend the SEC for its recognition of the problems and its effort to enact solutions. Yet, while focusing on a "top-down, risk-based approach" is well intentioned, the question ultimately has to be "will small companies finally see relief?" Based on preliminary reviews of the of the SEC and PCAOB proposals, our answer is "no". We do not believe the combined guidance put forth goes far enough to effect the necessary changes to relieve the SOX burden for smaller companies.

Although we are still reviewing both sets of documents, it is particularly troubling that the PCAOB in its release (page 5) states that "the Board believes that the changes made to the proposal reflect refinements, rather than significant shifts in approach." NVCA and its members do not believe that *refinements* will result in a reduction of the overwhelming costs faced by small companies. Refinements will not stop the drain on company resources that is threatening the continued leadership of the US capital markets.

Our concern is centered primarily on the intentions and behavior of the accounting profession. The recent proposals place too much power in the hands of the auditors that, in the face of both economic and liability concerns, are under tremendous pressure to take the most conservative and expensive auditing path. If the SEC wishes to enact reform measures that are meaningful, the Commission must exercise more strongly their jurisdiction over the PCAOB to insure that improvements will be significant enough to be *material* and will be carried out in the spirit in which they were intended.

The venture capital industry believes that three drivers are critical in this regard: First, we are gravely concerned that the accounting profession will not change its high cost practices and the recent guidance provided by both the SEC and the PCAOB regarding materiality is not specific enough to compel them to do so. Second, the oligopoly that exists for 404 audits leaves no choice for small companies in terms of service providers. It does provide any incentive for the Big 4 to lower costs. Lastly, because of these first two concerns, it is imperative that prior to adoption, all proposed measures are fully field tested to confirm that they will indeed reduce costs.

Raising the Materiality Threshold

One area of guidance where we have significant and immediate concern is the determination of what is and what is not "material" to sound financial reporting. The original SOX language set the probability threshold extremely low. Any area in which there was "more than a remote likelihood" for an error to result in a material mistake on the financials was required to be examined, documented, and reported on to the company's audit committee. This language comprised just about everything. The proposals put forth by both the SEC and PCAOB suggest changing the language to "reasonable possibility". We feel this general statement does nothing to distinguish itself from the original language, leaves everything open to interpretation, and will do little to reduce costs.

Chairman Cox has stated throughout the reform considerations over the last year that auditors and companies need to be focusing on the few key items that are really important and pose the most risk. Yet, the standard of materiality as revised will allow the accounting profession to continue to sweep in whatever areas they choose. Although in general we support the move to enact "principles based" guidance, we feel there should be an objective threshold if we are going to properly balance risk and cost.

Accounting Profession Reform

Since SOX was enacted in 2002, the relationship between the Big 4 accounting firms and venture backed companies has become increasingly problematic. Many of our small companies have lost the attention of their auditors as these Big 4 firms are favoring larger public companies who offer lucrative 404 auditing engagements. Those who do maintain their Big 4 relationships do so at a 404 cost that averages close to $1 million annually. As Sarbanes Oxley allows only for accredited accounting firms to complete 404 audits, our companies are held hostage to this oligopoly which is becoming increasingly untenable from both a cost and management standpoint.

We would not have these large concerns if we had any comfort level that the Big 4 accounting firms actually support SOX reform. But their actions in the field and on reform commissions suggest otherwise. In the last two years, the accounting profession led by the Big 4 has resisted SOX reform while reaping the benefits of lucrative 404 audit engagements. Further, they have publicly warned that the supporters of reform "shouldn't expect a dramatic reduction in costs" with the adoption of proposals. This is not only the publicly stated view of the Big 4 firms but, anecdotally, the specific message delivered to many of our members' portfolio companies in recent months. As our companies have entered the planning and fee-setting stages for their 2007 audits with the draft SOX reform proposals available, they are already being told that their auditors don't expect much, if any, savings in audit fees from the proposals as written. The Big 4 firms are advising our companies that they may have some benefits internally but the level of work the firms will have to perform to complete the internal controls attestation will be unchanged.

Just like smaller public companies, our private venture backed companies – the next Microsofts to which I earlier referred -- are also at the mercy of the Big 4. While one would believe that because these companies are private, they can engage a second tier accounting firm, in reality this is not a viable solution. Investment banks that ultimately take these companies public – or sell them to strategic buyers – require a Big 4 audit as a sign of a clean bill of health. Switching from a second tier firm to a Big 4 firm when the company approaches an IPO is impractical, not only because of the cost and time of reauditing the financials – which every new auditing firm requires in this situation – but also because in today's culture doing so wrongly implies to the market that the company must have something to hide. A company can switch to any other service provider as best fits its needs – lawyers, IT providers, banks. But they cannot switch accounting firms if they hope to go public. Our small companies are paying these large bills because there is no competition. We need to create a system where companies have quality choices outside of four large providers.

If the profession has no intention of being part of the cost lowering solution, US companies of all sizes should have the option to seek alternative service providers. The SEC should allow and Congress should publicly support the ability of accredited accounting professionals beyond the Big 4 to perform 404 attestations. By doing so, the SEC will create a healthy, competitive ecosystem where the market will set the right price for services rendered.

The Big 4 have a choice now to truly embrace cost reducing measures. If they continue to choose poorly, small companies should have the choice to find reasonable alternative providers.

Field Testing Prior to Adoption

Despite what we would consider an urgent need for reform, we will ask today that the SEC move forward cautiously when formalizing the proposed guidance. We can attest as builders of new enterprises that while the plans often look solid on paper, implementation is another story. It is worth taking that added time to ensure that reform recommendations are positioned for success.

Blindly adopting recommendations without field testing them first would be akin to purchasing a company without going through due diligence. Field testing ensures that 1) the recommendations will indeed reduce cost 2) all the players including the accounting profession are operating in the spirit of reform and 3) there are no unintended consequences. Understanding how the reform measures work in the real world before officially adopting them will allow the SEC to make adjustments as necessary without having to re-open a new process. Small companies have already had more than their share of unintended consequences as it relates to Sarbanes Oxley. Let's be sure to get it right – and prove that reform works – before declaring victory. We are willing to work with the SEC in this process.

Conclusion

It has been more than two years since the first public recognition that SOX costs were problematic. The worthy recommendations made by the SEC Advisory Committee on Smaller Public Companies after a comprehensive 13 month effort were largely dismissed. Since that time a Chamber of Commerce Committee, the Hal Scott Committee and others have spent time confirming the problem, but solutions have remained elusive.

We are at a critical inflection point and it has taken us a long time to get here. The good work of all involved will be for naught if the accounting profession does not get on board with cost reduction – or if implementation of the proposals fails. There are means by which we can mitigate these serious risks to reform. But the SEC must be deliberate and strong in their resolve. Taking the time to field test and placing the needed pressure on the Big 4 to join the effort is required. We have waited too long for this reform to take place – but we are willing to wait longer to make sure we get it right.

Thank you.

Statement of the U.S. Chamber of Commerce

ON:	**GETTING IMPLEMENTATION RIGHT: SARBANES-OXLEY SECTION 404 AND SMALL BUSINESS**
TO:	**HOUSE SMALL BUSINESS COMMITTEE**
BY:	**DAVID T. HIRSCHMANN, SENIOR VICE PRESIDENT, U.S. CHAMBER OF COMMERCE AND PRESIDENT, U.S. CHAMBER CENTER FOR CAPITAL MARKETS COMPETITIVENESS**
DATE:	**JUNE 5, 2007**

The Chamber's mission is to advance human progress through an economic, political and social system based on individual freedom, incentive, initiative, opportunity and responsibility.

Testimony before the House Small Business Committee

"Getting Implementation Right: Sarbanes-Oxley Section 404 and Small Business"

Testimony by David T. Hirschmann
Senior Vice President, U.S. Chamber of Commerce and
President, U.S. Chamber Center for Capital Markets Competitiveness

June 5, 2007

Good afternoon, Chairwoman Velázquez, Ranking Member Chabot, and members of the committee. My name is David Hirschmann and I am Senior Vice President of the U.S. Chamber of Commerce (the "Chamber") and President of its newly formed Center for Capital Markets Competitiveness (the "CCMC"). The U.S. Chamber of Commerce is the world's largest business federation, representing more than three million businesses and organizations of every size, sector, and region.

Introduction

I'm here today to discuss the impact of Sarbanes-Oxley ("SOX") Section 404 on small public companies as well as those seeking to access the capital markets. I will address four points in my testimony:

First, the Chamber would like to thank the chairwoman and the committee for holding this hearing and focusing on this important issue. We also welcome the recent initiative by the Securities and Exchange Commission ("SEC") and the Public Company Accounting Oversight Board ("PCAOB") to fix the implementation process of Section 404 to better reflect the intent of Congress and the needs of investors and companies. We view the PCAOB's new auditing standard as well as the SEC's guidance for companies as a significant step forward. We would like to commend Chairman Cox and Chairman Olson for their leadership, time, and energy to bring balance to the system.

Second, we believe that we will only know if these efforts have been successful after we see how they are implemented by auditors and companies and enforced by the PCAOB.

Third, until we have a full-year of experience with the new rules, we believe it would be a mistake to extend their application to smaller public companies.

Fourth, we urge Congress, the SEC, and other regulators to work together to address the additional critical issues that are making it harder and harder for leaders of smaller companies to access the public capital markets in order to grow their businesses and create jobs.

Background

More than 96 percent of the Chamber's members are small businesses with 100 or fewer employees, 70 percent of which have 10 or fewer employees. Yet, virtually all of the nation's largest companies are also active members. Besides representing a cross-section of the American business community in terms of number of employees, the Chamber represents a wide management spectrum by type of business and location. Each major classification of American business – manufacturing, retailing, services, construction, wholesaling, and finance – is represented. Furthermore, the Chamber has substantial membership in all 50 states.

The Chamber has strongly supported many of the reforms in Sarbanes-Oxley, including ensuring that boards are more active, independent, and composed of members with significant financial and other expertise. In particular, we believe that having effective and independent audit committees provides important oversight over the work of internal and external accountants. Effective internal controls are an essential part of good financial governance at all companies.

However, the implementation of Section 404 has led to costs and regulatory burdens far beyond what Congress intended and well in excess of the benefits to shareholders and management. This is amplified among smaller public companies due to economies of scale. Companies feel they are getting less effective advice and support from their external auditors, and auditors are increasingly being second-guessed by their new regulator and the trial bar.

The result is predictable: Companies increasingly feel that that the costs of being a public company outweigh the benefits, and an important tool companies have used to access capital is being eroded.

I know access to capital and the capital formation process is of particular interest to this committee. Small business drives much of the economic activity, innovation, and job creation in the United States. Over the last decade, for example, small businesses have generated 60 to 80 percent of net new jobs.[1] These businesses made up 97 percent of exporters and produced 28 percent of the known export value in FY 2005.[2] Small businesses employ 41 percent of high-tech workers and produce 13 to 14 times more patents per employee than large patenting businesses.[3]

For well over a century, this has been the greatest country on Earth for entrepreneurs and innovators to access low-cost capital to start and expand a business. Transparent and liquid public markets have been a key part of this. Without these markets, small firms can't get the venture capital or bank loans they need to buy new equipment, hire staff, or develop and market their products. Venture capital firms need a clear way get back their investment at a fair price. This usually means taking a company public. If the costs of becoming a public company are unnecessarily increased, then some companies will not get the venture capital they need, resulting in less innovation and competition within the marketplace. Banks also depend on the

[1] Small Business Administration Web site, http://app1.sba.gov/faqs/faqindex.cfm?areaID=24.
[2] *Id.*
[3] *Id.*

capital markets to securitize the loans they make to small companies, which allows for greater lending to small businesses.

Statistical evidence indicates that regulatory changes resulting from implementation of Section 404 of SOX have had a disproportionate impact on the cost of capital for smaller businesses that have already had to comply. For example, a $1 million to $2 million compliance price tag is an enormous burden on a company that has $3 million in net income.[4] A study released by the GAO in April 2006 stated that public companies with market capitalization of $75 million or less paid a median of $1.14 in audit fees for every $100 in revenues. This compares to $0.13 in audit fees for public companies with market capitalization greater than $1 billion.[5]

Fortunately, the costs associated with small business capital formation have come to the forefront of the agenda for financial markets' regulators. The SEC and PCAOB have made a good-faith attempt at providing scalable rules and guidance to smaller companies. The question now is will it be implemented as intended?

Correcting the Implementation of Section 404 of Sarbanes-Oxley

The Chamber has been strongly supportive of most provisions of SOX and believes that SOX has had positive effects in causing boards, management, and external auditors to be more thorough and attentive in fulfilling their responsibilities.

The problem has been, as almost everyone agrees, the failed implementation of Section 404. The 168 words that comprise Section 404, as well as the accompanying Auditing Standard 2 ("AS2"), have created regulation that produces costs far in excess of benefits, particularly for small companies. As Chairman Cox has noted, "Congress never intended that the 404 process should become inflexible, burdensome, and wasteful. The objective of Section 404 is to provide meaningful disclosure to investors about the effectiveness of a company's internal controls systems, without creating unnecessary compliance burdens or wasting shareholder resources."

U.S. Chamber members have frequently expressed concern that the implementation of Section 404 has had a negative effect on the competitiveness of U.S. companies and the U.S. capital markets, and created burdens on companies and their management well beyond what Congress intended. While Section 404 was fundamentally conceived as a disclosure requirement to provide more information about internal controls, under AS2 it has evolved into a substantive requirement for specific levels of internal controls that goes far beyond the Congressional mandate.

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[4] Comment by Clay Corbus, Town Hall Meeting, Commission on the Regulation of U.S. Capital Markets in the 21st Century, San Francisco, October 12, 2006.

[5] U.S. Government Accountability Office, Report to the Committee on Small Business and Entrepreneurship, *U.S. Senate, Sarbanes-Oxley Act: Consideration of Key Principles Needed in Addressing Implementation for Smaller Public Companies*, at 17. (April 2006) (GAO Report) available at: http://www.gao.gov/new.items/d06361.pdf.

When the SEC and PCAOB issued proposed revisions in December 2006, the Chamber voiced a number of concerns (see comment letter available at: http://www.sec.gov/comments/s7-24-06/s72406-213.pdf). Key recommendations included: ensuring a reasonable cost-benefit balance; performing a cost-benefit analysis after the rules are adopted; aligning SEC management guidance with AS5; clarifying terms such as material weakness, significant deficiency, and materiality; clarifying Auditing Standard 3; aligning Auditing Standard 4 with AS5; ensuring that the rules are both risk-based and scalable; providing more certainty regarding the proposed safe harbor; educating the public about the role and scope of an audit and that a restatement does not necessarily indicate a material weakness; allowing for greater use of the work of others; providing specific guidance on IT systems and controls; and promulgating additional guidance on footnote disclosure controls. The Chamber also raised serious concerns about the extent to which the new standards will improve "on the ground" implementation.

It remains to be seen if all these problems have been addressed, and we encourage the SEC to issue its management guidance for public review as soon as possible. We also urge the PCAOB to update the inspections process to ensure that it is consistent with the new rules put forth.

A Delay for Smaller Companies

The Chamber has called for a further delay in compliance with Section 404 for smaller public companies until the new rules and guidance have been fully tested by larger companies. Note that only companies with a market capitalization greater than $75 million have had to comply with Section 404 to-date. With a further delay for smaller businesses, we will be better able to leverage the experience of larger companies and the auditing profession to ensure that implementation costs are minimized. Failure to do this could significantly undermine the cost-cutting objectives of the new standards. We also need to remain prepared to make additional changes if the new rules don't work as intended.

As it stands today, smaller companies will have to begin complying with the management requirements of Section 404(a) in their annual reports for fiscal years ending on or after December 15, 2007. They will have to comply with Section 404(b) requiring an auditor's attestation report on internal control over financial reporting in their annual reports starting with the first annual report filed for the fiscal year ending on or after December 15, 2008.

Two of the five SEC Commissioners—Commissioner Atkins and Commissioner Casey—have publicly indicated a willingness to reconsider such a delay. The Senate Committee on Small Business and Entrepreneurship led by Chairman Kerry and Ranking Member Snowe held a hearing on April 18, and the Senators have publicly called for a further delay. The Small Business Administration has also joined in to ask the SEC to revisit the issue of compliance deadlines. We urge this Committee to support this call for a reasonable, additional one-year extension for smaller issuers.

Additional Reforms to Enhance Small Business Competitiveness and Job Creation

The Chamber believes that SOX has become a catch-all term to refer to a broader set of issues facing the public markets and smaller public companies in particular. While Section 404 is a significant part of the problem, it is not the only part. U.S. companies are facing changing, retroactively applied accounting rules that are ever-increasing in complexity. As a result, one in 10 public companies was forced to restate its earnings last year. This system is not working for companies, investors, or auditors.

America's securities class action litigation system is broken. It provides inadequate compensation to injured parties without deterring future wrongdoers. It fails to protect small, undiversified investors, who seldom receive more than pennies on the dollar, while attorneys on both sides rake in millions of dollars in fees. Moreover, several recent bipartisan reports have highlighted the damage done by the private securities litigation system to U.S. competitiveness in the global capital markets and, as a result, to the U.S. economy as a whole. The system is not working.

We have a regulatory structure filled with duplicative, inefficient, and, in some cases, contradictory guidance. Regulators have struggled to keep up with the speed and technology changes of today's rapidly changing markets. While no business should be forced to read the minds of the regulators, it is particularly difficult for smaller public companies to deal with these issues. The system is not working.

What Can We Do?

The challenge is clear and the voices are growing. The Chamber's independent, bipartisan Commission on the Regulation of U.S. Capital Markets in the 21st Century and others, including Hal Scott from Harvard, and Senator Schumer and Mayor Bloomberg have echoed that the problems facing our competitiveness are real and action is needed. We should remain united in our goal to make the U.S. capital markets the fairest, most efficient, transparent, and attractive in the world.

That is why the Chamber formed the Center for Capital Markets Competitiveness in March 2007. The Center was established to advance legislative, regulatory, and legal initiatives designed to strengthen the competitiveness of U.S. capital markets.

Granting a further delay for small business in complying with Section 404 would be a good step towards addressing these larger issues. But we cannot stop there. We need broad litigation and regulatory reform to retain our global capital markets leadership.

Conclusion

Chairwoman Velázquez, Ranking Member Chabot, and members of the committee, thank you for the opportunity to discuss these serious issues. The Chamber stands ready to work with you and others to improve the implementation of SOX 404—and we congratulate you for taking this important step by holding today's hearing. We also applaud Chairman Cox and Chairman Olson for the work they have done.

In summary, we believe that we will only know if the efforts of the SEC and PCAOB have been successful until after we see how they are implemented. Therefore, we are calling for a further delay of one full-year for smaller public companies before they must comply with Section 404. Finally, we urge Congress, the SEC, and other regulators to work together to address the additional critical issues that are making it increasingly difficult for leaders of smaller American companies to access the public capital markets to grow their businesses and create jobs.

Thank you again for the opportunity to be here today. We stand ready to take action on behalf of the business community to provide viable solutions.

Graydon Head & Ritchey LLP

U.S. HOUSE OF REPRESENTATIVES

Committee on Small Business

Sarbanes-Oxley Section 404: Will the SEC's and PCAOB's New Standards Lower Compliance Costs for Small Companies?

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Opening Remarks

Good afternoon, Madame Chairwoman Velázquez, Ranking Member Chabot, and Members of the Committee. Thank you for inviting me to testify on the new standards for internal controls over financial reporting recently established by the Securities and Exchange Commission and the Public Company Accounting Oversight Board. The costs and related burdens of implementing Section 404 of Sarbanes-Oxley have been, and continue to be, a serious problem for public companies, particularly smaller companies. I appreciate the Committee's desire to further investigate ways to alleviate these problems.

I am a partner in the Cincinnati, Ohio office of the law firm of Graydon Head & Ritchey LLP. As the Chair of our securities law practice, I work with both large and small public companies in a variety of industries. My testimony today is based on my 25 years of experience in representing, counseling and building relationships with my firm's public company clients and their boards of directors, chief executive officers and chief financial officers in their real world experiences in navigating the regulatory requirements imposed upon public companies. Since the enactment of Sarbanes-Oxley nearly five years ago, I have worked more closely than ever with public companies in helping them become Sarbanes-Oxley compliant. As a result, I have gained substantial insights as to how directors and officers view these increasingly complex requirements.

In preparing my testimony, I have asked a number of officers of several different public companies about their current thoughts and expectations about Section 404 and the new SEC and PCAOB standards. However, the views that I share with the Committee today are my own views and should not be attributed to Graydon Head & Ritchey or to any client of my law firm.

My objective is to address three primary topics with the Committee: (1) the most significant problems that implementation of Section 404 has caused for public companies; (2) whether the SEC's and PCAOB's new standards are likely to effectively alleviate those problems; and (3) the need to continue to evaluate whether Section 404 is serving its intended purposes.

1. Significant Problems Caused by Section 404

This Committee, the SEC and the PCAOB are well aware that the implementation of Section 404 of Sarbanes-Oxley has been problematic. I will not attempt to identify every problem that public companies have encountered in seeking to comply with the Section 404 requirements for internal controls over financial reporting as the myriad of problems are well documented in various reports compiled by the SEC. What I will do is to emphasize that the most significant and troubling problems facing public companies, and particularly smaller public companies, are (1) out-of-pocket costs, (2) diversion of limited internal resources, and (3) deteriorating relationships with their independent, outside auditors.

- **Out-of Pocket Costs:** The additional out-of-pocket costs required to comply with Section 404 are extremely high. Virtually every public company that I have talked with has experienced at least a doubling of its audit costs each year since being subjected to Section 404 compliance. Initially, the extra cost burden in the first year of

implementation was seen as extreme by most companies, however, they have now discovered that these costs do not significantly reduce in subsequent years.

Importantly, studies have also confirmed that the cost of Section 404 compliance is disproportionately higher with respect to smaller public companies. Although a larger company may have incurred an additional $2.0 million of auditing costs attributable to Section 404 compared to only $500,000 by a smaller company, the larger company typically is offsetting those costs against a much larger bottom line. If the smaller company only generated $1.0 or 2.0 million in net income to begin with, the extra compliance costs very materially reduce such net income and directly lowers the value of the company for its shareholders.

- **Diversion of Limited Internal Resources:** In addition to direct costs, public companies must also allocate substantial internal human resources to the Section 404 compliance process. Those costs are hard to measure precisely, but public companies firmly believe that the substantial time that many key employees must devote to Section 404 compliance would better benefit shareholders if focused on running and growing the company's business. Again, this problem is even more pronounced for smaller public companies who have fewer employees and who frequently have significant budget restraints on hiring additional employees. The result is that highly qualified chief financial officers and controllers must do much of this work themselves in smaller public companies, yet the involvement of these individuals is greatly needed in other aspects of the business as well.

- **Deteriorating Relationships with Independent, Outside Auditors:** Section 404 compliance has been a major contributor to a deteriorating relationship between public companies and their auditors. In the past several years, I have heard numerous public company officers describe their relationship with their outside auditors as "adversarial." I don't recall ever having heard such comments prior to the implementation of Section 404. We all agree that it is critically important that a company's outside auditors be independent of management, but Section 404 has had the unintended consequence of cutting off productive and necessary consultations with the auditors who historically had been among a company's most trusted advisors.

  The reason for this problem is that many companies discovered that if they had to ask their auditors for advice on how to handle complex accounting issues, then the auditors felt compelled to characterize the need to ask as either a significant deficiency or worse, a material weakness because the company should have known. Of course, this is a fallacy in that many accounting, tax and other issues require much judgment and analysis. Nonetheless, the fear of being tagged with having material weaknesses causes smaller public companies to no longer ask legitimate questions for needed advice. The company either makes a judgment the best it can based on the amount of time its key people can devote to analyzing the relevant issues, or the company can incur even more additional expense by engaging yet another accounting firm to advise it on those matters notwithstanding that such other accounting firm does not know nearly as much about the company as does the company's current audit firm. The frustration experienced by small public companies in these cases is exacerbated by the fact that the outside auditors also

frequently would not have had definitive answers, yet management is not even able to determine the auditors' general thinking on these complex matters until the Section 404 audit is underway months later.

The relationship between a company and its auditors has been further strained by the Section 404 process in cases where a company perceives their outside auditors as being inflexible, lacking judgment and/or conducting excessive testing and analysis of internal controls regardless of materiality. Although the auditors in the field historically are very familiar with their audit client's business, many audit firms have taken a centralized approach to Section 404 which has resulted in a "if it's good for Company A, then it must be good for Company B" mentality. This has caused auditors to insist on implementation of various procedures and the undertaking of extensive testing on many matters that are not seen as being at all relevant to the particular company being audited. Because these requirements are being imposed from above, i.e. the audit firm's national office or in some cases the PCAOB, the auditors in the field are powerless to adapt even if they would otherwise be so inclined. The reluctance of audit firms to make modifications is undoubtedly (and justifiably) also tied to liability concerns given that the accountants have been the deep pockets for substantial claims based upon their client company misconduct or mistakes.

I emphasize these problems because I can assure you that these problems are in fact being experienced virtually everyday by our nation's public companies. These problems are draining not only cash from otherwise solid and viable companies, but also adversely impact the entrepreneurial spirit of these officers in wanting to build a company for the long term. More and more public companies have no choice other than to at least consider the possibility of going private and exiting the public markets altogether.

I also work with many successful privately held companies, including entrepreneurial new ventures. Ten years ago, it was very common for these companies to aspire to someday go public and to use the public capital markets as a way to grow the company. In today's environment, these types of companies express virtually no interest in going public and cite the regulatory burdens as the main concerns. While the aggregate dollar volume of IPOs may be on the rise in recent years, increasingly it is the case that the public markets are not truly open for smaller companies. My first underwritten public offering in 1986 raised a whopping $600,000 in gross proceeds. While that was atypically small even then, it would be difficult to recommend that any company conduct an IPO today for less than $100 million.

Yet another ominous sign for the U.S. public markets is the new unregistered stock trading system recently devised by Goldman Sachs. This system is designed to create a trading market in privately held companies but to keep them at less than 500 shareholders so not to trigger SEC reporting obligations. Investments in these "listed private companies" will be limited to institutional investors, thereby limiting investment opportunities for the general public. Perhaps even more telling is that a leading investment banking firm would believe that such an unregistered trading system is advantageous given that the public capital markets have been the life blood of investment banking.

I believe the case is clear that small companies need relief from the enormous regulatory burdens being imposed upon them. While Section 404 is by no means the sole cause of those burdens, it is an area ripe for improvement as I will next discuss.

2. Anticipated Ability of New SEC and PCAOB Standards to Remedy Section 404 Problems

The SEC and PCAOB have expended extraordinary time and effort to identify, analyze and attempt to develop solutions for the myriad of problems resulting from Section 404. This is evidenced by the large number of hearings, public meetings, proposal drafts, comment solicitations and other related actions to try to balance the needs and burdens on public companies with the need for quality reporting and confidence in the public markets. These actions are highly commendable and should be greatly appreciated. I believe that the SEC and PCAOB have done an excellent job of developing standards that, in theory, should alleviate some of the above problems.

The SEC and PCAOB's new standards contain many concepts that do address the main problems posed by Section 404. Companies and auditors are being guided to take a top down approach focusing on identifying the true risk areas and materiality. The new standards also contemplate scalability and recognize that all companies are not the same and that the nature and types of controls needed in various companies can vary. Of great significance is that the new standards allow for the auditors to undertake work relating to internal controls if the company's audit committee approves. The new standards also allow the auditors to rely on the work of company employees, not just the internal auditors which many smaller public companies do not have. The combination of these factors should reduce costs and improve relationships between companies and their auditors.

Unfortunately, I must report to you that smaller public companies are for the most part highly skeptical that the new standards will bring actual relief. In some instances, this skepticism results from conversations that have already transpired between the public company and its auditors. Those conversations have made clear that the auditors are not anticipating any significant changes in the way they approach the Section 404 audits, notwithstanding the new standards. If the auditors are not willing in practice to buy into the new standards, then it is highly doubtful that public companies will experience any meaningful cost reduction in Section 404 compliance or that internal resources will be freed to focus on the company's operations, strategy and vision which ultimately build shareholder value. While we can only speculate at this point at to why auditors may not embrace the new standards, reluctance to change their processes may well be due to concerns of potential liability if their practices are not uniformly applied.

Even as to those companies which are more optimistic about the willingness of their auditors to work within the new standards, their expectation as to cost savings is modest. At this point, they anticipate that a 10 – 15% reduction in audit costs is about the best that would result. Those companies that are already complying with Section 404 also have concern that it will be costly to convert to the new standards as much of the same work that was needed in the initial implementation of Section 404 would have to be repeated in order to determine what items can be scaled back. Now that they have experienced at least two years of the Section 404 audit, it

may be easier and more cost effective to simply keep the existing processes substantially in place. These companies believe that as long as they can continue to demonstrate to their auditors that they are following the established internal control procedures that were sufficient to allow the company to get a "clean" Section 404 report, then it would not be prudent to change those procedures at the risk of getting a different result.

Recommendation #1. The primary perceived obstacle to the potential success of the SEC's and PCAOB's new standards is the willingness and ability of the outside auditors to adapt their thinking and procedures to align with the principles and guidance set forth in those standards. Because the PCAOB is charged with overseeing and evaluating public accounting firms, the PCAOB should make clear that part of its evaluation process will be to determine whether the audit firms are changing from a "one size fits all" and "everything is material" standard. Although the PCAOB has limited powers, the PCAOB needs to strongly encourage public accounting firms to buy into the new standards and to be critical of firms that do not. While beyond the power of the PCAOB and the SEC, reducing the potential liability of auditors for Section 404 audits could be warranted.

Recommendation #2. The SEC should grant non-accelerated filers another extension of time before compliance with the new standards is required. So far, the SEC has determined not to provide additional time notwithstanding the cry of many interested parties requesting such an extension.

An extension is warranted for several reasons, including:

- First, to begin with, the phased implementation of Section 404 presumably was to allow smaller companies to learn from the experiences of larger companies and their auditors in implementing Section 404. The new standards create a substantially new and different framework for implementing and auditing internal controls than what the large accelerated filers and accelerated filers have experienced in prior years. The smaller public companies should not be the guinea pigs in determining how to implement the new standards.

- Second, the accounting firms need time to review their practices and procedures in light of the new standards and to modify those practices and procedures as they deem appropriate. The accounting firms also need time to educate their own staffs on such changes before the internal control auditing process is undertaken. Moreover, if the non-accelerated filers are now added to the number of companies for which internal controls must be audited, there undoubtedly will be even more new hires by the accounting firms to handle the increased demand, many of which new hires may have little or no experience in auditing internal controls under either the old or new standards.

- Third, the non-accelerated filers have already lagged behind their larger public company counterparts in implementing Section 404 without any indication that the public markets and investors have been clamoring for these companies to commence compliance. Another time extension of one or more years, if not permanently, would not appear to greatly increase risk to the markets or investors.

3. Continued Evaluation of the Effectiveness of Section 404

In reading the various proposals and related materials prepared by the SEC and the PCAOB, it is apparent to me that they have concluded that (1) Section 404 is improving the quality of financial reporting, decreasing the risk of fraud and improving investor confidence, and (2) reducing the cost of implementing Section 404 will eliminate the majority of concerns and objections that public companies have regarding Section 404.

I believe that declaring Section 404 to be effective in the above respects is premature, if not entirely incorrect. I also believe that reducing the Section 404 costs will not mean that Section 404 compliance is cost effective.

In talking with public companies about Section 404, they are virtually unanimous in their strong belief that they had good internal controls before Section 404 was thrust upon them and that Section 404 has not been effective, and cite the following examples:

- The additional documentation and procedures that they have been forced to adopt in order to satisfy the auditors have been largely focused on minutiae and are unnecessary.

- Their financial reporting is not significantly improved as a result of implementing Section 404, and believe that the public markets and investors do not place significant value on the internal control reports.

- Many companies have had to restate their financial statements in recent years, but not because their internal controls were more effective. Large numbers of restatements have been necessary due to the ever increasing complexity of accounting rules and tax laws, which require companies to use their best judgment on how to report certain items. In subsequent years, as companies and auditors gain more experience in applying those new rules and standards begin to emerge, it is not uncommon for companies to later discover that their best judgment did not comport with the prevailing view and then the prior years' numbers must be adjusted. Fortunately, knowledgeable investors are increasingly able to distinguish between restatements that are driven by highly technical rules and restatements that indicate serious problems within a company.

  It is also clear that many of the restatements are being made by companies that had received clean audit reports on their internal controls for the years being restated. In many of those cases, the need to restate triggers a determination by the company and/or the auditors that a material weakness had existed so the audit report gets changed months or even years later. In those cases, it is difficult to conclude that financial reporting has been improved or that the financial statements are more reliable because of the auditor's Section 404 audit report.

While many of the Sarbanes-Oxley requirements have been beneficial to companies, their shareholders and the investing public, the jury should remain out on Section 404. Many public companies would urge Congress to repeal Section 404 for the various reasons, including those discussed above.

Although it is my understanding is that it is highly unlikely that Section 404 will be repealed, I would be remiss if I did not ask this Committee to at least remain open to that possibility. Failing the complete repeal of Section 404, I would suggest to the Committee that the current batch of non-accelerated filers who have not yet been required to comply with Section 404 and new public companies in the future be exempt from Section 404 implementation until such time as they achieve certain thresholds. The market capitalization threshold should be increased substantially, at least to $500 million and arguably higher. A net income test should also be established to alleviate the disproportionate impact of compliance costs on smaller companies. While changing these thresholds will not benefit companies that have already complied with Section 404, this step would help minimize concerns of companies considering going public that the ongoing compliance costs are too high to overcome.

Conclusions

The implementation of Section 404 continues to be a significant burden for public companies, even more so for smaller companies. The SEC's and PCAOB's new standards may alleviate some of those problems, but Section 404 is likely to continue to be particularly burdensome on small public companies for years to come. Ideally, Section 404 itself would be repealed, or at least the nation's small public companies could be granted a longer term exemption from compliance.

I appreciate the opportunity to appear before you today to address these important issues. I will welcome any questions that you may have. Thank you.

ICBA
INDEPENDENT COMMUNITY
BANKERS of AMERICA

Statement on behalf of the

Independent Community Bankers of America
Washington, DC

Sarbanes-Oxley Section 404: Will the SEC's and PCAOB's New Standards Lower Compliance Costs for Small Companies?

United States House of Representatives

Committee on Small Business

June 5, 2007

The Independent Community Bankers of America (ICBA)[1] appreciates the opportunity to offer this statement before the House Small Business Committee concerning the impact that the new guidance and standard under Section 404 of the Sarbanes-Oxley Act of 2002 (SOX) will have on small business. Section 404 requires publicly held companies to include an assessment by management of the effectiveness of a company's financial controls and procedures in their annual reports and to have the company's auditor attest to the effectiveness of the company's internal controls and procedures.

Approximately two weeks ago, the Securities and Exchange Commission (SEC) approved new guidance for management under SOX Section 404(a) (the "SEC Guidance"). At the same time, the Public Company Accounting Oversight Board (PCAOB) approved a new internal control auditing standard under SOX Section 404(b), *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements* (referred to hereafter as Auditing Standard No. 5 or "AS5"), that would supersede Auditing Standard Number 2. The purpose of both the SEC Guidance and AS5 is to (1) clarify the requirements of SOX Section 404(a) for management and (2) simplify and scale the internal control audit required by Section 404(b) so that outside auditors would focus on those matters most important to internal control.

Summary of ICBA's Position

- While the SEC Guidance and AS5 may curtail excessive testing of controls and reduce some of the unnecessary documentation required by SOX 404 audits, ICBA still has doubts that it will reduce 404 audit costs, particularly for smaller public companies.

- ICBA is disappointed that the SEC did not adopt our recommendation to delay by one year the Section 404 due dates for non-accelerated filers so that they would have until the due date for their 2008 annual report to file their management internal control reports and the due date for their 2009 annual report to file the auditor's attestation report. The additional one-year delay would have given the SEC and the PCAOB an opportunity to evaluate the impact and the cost effectiveness of their proposed guidance on accelerated filers and would also have given non-accelerated filers that have no experience with Section 404 additional time to understand and apply the new guidance and establish a new internal control framework.

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[1] *The Independent Community Bankers of America represents the largest constituency of community banks of all sizes and charter types in the nation, and is dedicated exclusively to representing the interests of the community banking industry. ICBA aggregates the power of its members to provide a voice for community banking interests in Washington, resources to enhance community bank education and marketability, and profitability options to help community banks compete in an ever-changing marketplace.*

With nearly 5,000 members, representing more than 18,000 locations nationwide and employing over 265,000 Americans, ICBA members hold more than $876 billion in assets $692 billion in deposits, and more than $589 billion in loans to consumers, small businesses and the agricultural community. For more information, visit ICBA's website at www.icba.org.

- To indicate that it is serious about reducing costs, ICBA believes that the SEC should have set a quantitative benchmark or goal for the new standard that would be tied to a reduction in overall SOX 404 audit costs.

- While a risk-based and scalable AS2 may reduce some of the high costs of SOX Section 404, ICBA still believes that smaller public companies should be partially or fully exempted from Section 404 in order to be competitive with larger companies and foreign competition.

Comments Concerning AS5 and the SEC Guidance

We commend the SEC and the PCAOB for their efforts to create a scalable, top-down approach for SOX 404 audits. As noted in the release for the proposed SEC Guidance, the SEC Advisory Committee on Smaller Public Companies raised a number of concerns regarding the ability of smaller companies to comply cost-effectively with the requirements of SOX 404. Some of the concerns stemmed from the implementation of AS2 and the fact that auditors were engaged in excessive testing of controls and requiring unnecessary documentation to comply with SOX 404.

We also commend the PCAOB for aligning AS5 more closely with the SEC guidance and making the new standard more scalable for smaller public companies. By using the same definitions of "material weakness" and "significant deficiencies" in AS5 that the SEC uses in its final management guidance, the PCAOB has gone a long way in making the new standard more in sync with the SEC guidance. Eliminating the "principal evidence" provision and changing walkthroughs from a mandatory requirement to a recommended step will help make AS5 more flexible for smaller public companies.

However, while the SEC Guidance and proposed AS5 may curtail excessive testing of controls and reduce some of the unnecessary documentation required by SOX 404 audits, we still have doubts that it will reduce 404 audit costs, particularly for smaller public companies. We note, for instance, that AS5 has not been field tested so there is no evidence to suggest that, despite the proposed standard's focus on scalability and risk-based testing, auditors will significantly change their audit procedures or reduce the time they take to perform a 404 audit.

ICBA is disappointed that the SEC did not adopt our recommendation to delay by one year the Section 404 due dates for non-accelerated filers so that calendar year filers would have until the due date for their 2008 annual report rather than the due date of their 2007 annual report to file their management internal control reports. The one-year delay would have accomplished several things. First, it would have given the SEC and the PCAOB an opportunity to evaluate the cost effectiveness of their controls on accelerated filers. If, for instance, the SEC Guidance and AS5 would have had little impact on SOX 404 audit costs for the 2007 and 2008 accelerated filers, then the SEC and the PCAOB would have time to revise the guidance and the new standard before it is fully implemented by non-accelerated filers. Second, a one-year delay would also have given non-accelerated filers that have no experience with Section 404 additional time to understand and apply the new guidance and establish a new internal control framework. As it stands, non-accelerated filers will have a very limited time—

approximately six months—to prepare the management assessment of controls in accordance with the new guidance.

ICBA also believes that the SEC and the PCAOB should have established a quantitative benchmark or goal for the new standard that is tied to a reduction in overall SOX 404 audit costs. For instance, the SEC and the PCAOB should have stated that the goal of AS5 is to reduce average internal control audit costs by a certain percentage—say 20%, with a commitment that if the revised standard does not meet that goal, then the standard would be revised further. It is too ambiguous for the SEC or the PCAOB to state that their goal is to increase the "cost effectiveness of the 404 audit" or "to eliminate unnecessary audit procedures" particularly when there has been no field testing of the new standard and therefore no assurance that it will reduce costs. A specific benchmark or goal would have conveyed to the industry that the SEC and the PCAOB is serious about reducing the overall costs of SOX 404 and is committed to achieving that goal.

Defined Terms Need to be Clearer

While we agree that the SEC and the PCAOB have made some progress in clarifying some of the defined terms used in AS2, we believe there is more room for improvement. Specifically, there will still be confusion about what constitutes a "material weakness" and how management should identify material weaknesses. AS2 currently defines a material weakness as a control deficiency, or a combination of control deficiencies, that result in more than a remote likelihood that a material misstatement of the company's annual or interim financial statements will not be prevented or detected. In AS5 and SEC Guidance, the SEC and the PCAOB use the same definition but substitute "reasonable possibility" for "more than a remote chance."

While "reasonable possibility" is clearer than "more than a remote chance" and possibly raises the threshold to some degree, the definition still requires management and auditors to prove a negative—that no material weaknesses exist—as opposed to affirmatively proving the effectiveness of internal controls. This negative approach—proving that no material weaknesses exist—places an enormous burden on auditors and management who must attest to the internal control over financial reporting and encourages them to be very conservative with their testing and documentation.

ICBA believes a more precise definition of "material deficiency" that is tied to the impact on a company's earnings would have been very helpful. Last year, ICBA supported the COMPETE Act,[2] introduced by Rep. Tom Feeney (R-Fla.), that directed the SEC and the PCAOB to use a 5% de minimus standard (e.g., 5% of profits) under AS2 for noting material deficiency. Furthermore, if management and the auditors must prove the negative—that there are no "material deficiencies" in their internal controls—then greater clarity as to how companies both large and small can achieve that goal would have been beneficial. The guidance should also have indicated at what point a combination of control deficiencies give rise to a material weakness. Illustrations of

[2] HR 5404, known as the "Competitive and Open Markets that Protect and Enhance the Treatment of Entrepreneurs Act."

different control deficiencies that rise to a material weakness would be useful. Both the SEC Guidance and AS5 should be clear enough so that management does not have to consult with their auditors every time there is an issue about a "material deficiency."

There are other examples of defined terms that should have been clarified. For instance, the SEC Guidance indicates that management is required to assess whether a company's internal controls are effective in providing "reasonable assurance" regarding the reliability of financial reporting. "Reasonable assurance" is defined as assurance that would "satisfy prudent officials in the conduct of their own affairs." This definition is entirely too vague. At a minimum, the SEC should have provided illustrations so that companies have a clearer idea of what it means to be "reasonably assured." As mentioned above, the guidance should be clear enough that management does not have to constantly refer to experts (i.e., an outside auditor) to understand the definitions.

The SEC Guidance Should Provide a Clear Safe-Harbor for Management

The SEC Guidance says that the proposed amendments to Rules 13a-15(c) and 15d-15(c) will make the SEC Guidance "similar" to a non-exclusive safe-harbor. ICBA recommended that the SEC provide a <u>clear</u> safe harbor for management under the Securities and Exchange Act of 1934 provided that management has complied with all aspects of the SEC Guidance. A clear safe harbor would make it more likely that management will detect material weaknesses and disclose them since management will realize that it has some legal protection under the Exchange Act. Furthermore, management will be more likely to rely on its own interpretation of the guidance and not constantly seek advice from auditors.

The SEC rules contain a number of safe harbors that have been very successful, including Rule 144A under the Securities Act of 1933 which provides a safe harbor from registration for re-sales of privately placed securities to qualified institutional buyers and Regulation D, which is a safe harbor from registration for certain private placements of securities. In each case, these safe harbors have provided a clear way for parties to comply under the securities laws. The SEC should provide a clear safe harbor for management under the Exchange Act that provides legal protection similar to these other safe harbors.

Even With a Scalable AS5, ICBA Endorses a Small Company 404 Exemption

ICBA commends the SEC and the PCAOB for their endorsement of a scalable approach to SOX 404 audits. AS5, for instance, does incorporate a discussion of scaling concepts, similar to what was proposed, throughout the final standard. Specifically, notes to relevant paragraphs in the new standard describe how to tailor the audit to the particular circumstances of a smaller, less complex company. We understand that AS5 will provide the foundation for planned guidance on auditing internal control in smaller companies to be issued later this year.

While a risk-based and scalable AS2 may reduce some of the high costs of SOX Section 404, ICBA still believes that smaller public companies should be partially or fully exempted from Section 404 in order to avoid unnecessary costs and to be

competitive with larger companies and foreign competition. Even with a revised auditing standard, we believe that smaller public companies would still be subject to unnecessarily extensive auditing of detailed control processes under Section 404 by auditors unduly concerned about their liability and being second guessed by the PCAOB.

ICBA strongly endorses the primary recommendations of the SEC's Advisory Committee on Smaller Public Companies including (a) exempting micro-cap companies (with equity capitalizations of $128 million or less) that have revenue of less than $125 million from the internal control attestation requirements of SOX Section 404 and (b) exempting small-cap companies (with equity capitalizations of between $128 million and $787 million) that have revenue of less than $250 million from the external audit requirements of SOX Section 404. We agree with the Advisory Committee that with more limited resources, fewer internal personnel and less revenue with which to offset the costs of Section 404 compliance, both micro-cap and small-cap companies have been disproportionately impacted by the burdens associated with Section 404 compliance. We also agree that the benefits of documenting, testing and certifying the adequacy of internal controls, while of obvious importance for large companies, are of less value for micro-cap and small-cap companies, that rely to a greater degree on "tone at the top" and high-level monitoring controls, to influence accurate financial reporting.

The proportionately larger costs for smaller public companies to comply with Section 404 adversely affect their ability to compete with larger public companies and even with foreign competition. This reduction in the competitiveness of U.S. smaller public companies hurts their capital formation ability and, as a result, hurts the U.S. economy.

For community banks, Section 404 costs have been particularly significant. ICBA's 2005 survey of Section 404 costs for community banks revealed that the average community bank would spend during 2005 more than $200,000 and devote over 2,000 internal staff hours to comply with Section 404.[3] These costs far outweigh the benefits for these small companies.

Conclusion

ICBA is disappointed that the SEC did not grant another one year delay in the Section 404 due dates for non-accelerated filers so that they would have until the due date for their 2008 annual report to file their management internal control reports and the due date for their 2009 annual report to file the auditor's attestation report. The additional one-year delay would have given the SEC and the PCAOB an opportunity to evaluate the impact and the cost effectiveness of their proposed guidance on accelerated filers and would also have given non-accelerated filers that have no experience with Section 404 additional time to understand and apply the new guidance and establish a new internal control framework.

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[3] For a complete description of ICBA's Section 404 Survey of Community Banks, see ICBA's comment letter to the SEC dated March 31, 2005 concerning the formation and goals of the Advisory Committee.

To indicate that it is serious about reducing costs, ICBA also believes that the SEC should have set a quantitative benchmark or goal for the new standard that is tied to a reduction in overall SOX 404 audit costs. While a risk-based and scalable AS2 may reduce some of the high costs of SOX Section 404, ICBA still believes that smaller public companies should be partially or fully exempted from Section 404 in order to avoid unnecessary costs and to be competitive with larger companies and foreign competition.

ICBA appreciates the opportunity to offer this statement before the House Small Business Committee concerning the impact that AS5 and the SEC guidance under Section 404 of the Sarbanes-Oxley Act will have on small business.

Institute of Management Accountants

Testimony On

Application of Sarbanes-Oxley Regulations in Small Companies

Prepared for

House of Representatives Small Business Committee

Nydia M. Velázquez, Chairwoman

June 5, 2007

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The Institute of Management Accountants ("IMA") has been an active and critical commentator on SOX regulatory regime over the past 2 years. With a worldwide network of nearly 65,000 professionals, IMA is the world's leading organization dedicated to empowering accounting and finance professionals to drive business performance.

Given the importance and impact of the current regulatory regime on U.S. global competitiveness we have invested considerable resources researching issues linked to the practicality, efficiency, and effectiveness of the current SOX section 404 regulations. Most recently we viewed the SEC webcast on May 23 announcing the new SEC guidance for management, studied the transcript of the webcast, viewed the PCAOB webcast on May 24th outlining the key elements of the new guidance for external auditors, and have carefully studied the text of Auditing Standard No. 5 issued on May 24th -- all with the historical predicate of having completed an independent multi-year study, surveying its members, conducting roundtable meetings for Congressional Members and staff, and participating in the bill-drafting process.

IMA's conclusion is that the May 2007 SOX section 404 implementation guidance is still seriously sub-optimal and that further delay, backed by a more radical and time-bound action plan, is necessary for small companies. It is our opinion that full implementation of the costly and error-prone control assessment methods proposed in the revised regulations will negatively impact the growth, success and global competitiveness of the more than 12,000 U.S. listed non-accelerated filers. We do not consider the internal control over financial reporting (ICFR) assessment approach mandated by the SEC or PCAOB in the latest revisions to be in line with global risk management standards that allow testing and documentation to be focused on the high risk areas. Most disturbingly, there is a growing amount of evidence that indicates the current control assessment methods mandated by Auditing Standard No. 2 have high prediction error rates. Large accelerated filers are better able, both in terms of financial resources and personnel, to deal with the burden that comes with the onerous and unnecessary regulatory costs (direct and indirect) that we believe will still accompany the revised SOX 404 regulations. The flaws in the current regulatory regime have the potential to significantly harm smaller public companies and undermine U.S. competitiveness.

The fact that the SEC has publicly stated during the May 23 webcast that they are either unable and/or unwilling to project the magnitude of any cost reduction that may accompany this new guidance relative to the current 404 regulatory regime should be a major cause for concern. During the SEC May 23 webcast Ms. Murphy, in response to a question from Commissioner Atkins that touched on the massive SEC section 404 implementation cost estimation error made in June 2003, shed little light on the specifics of how the new SEC regulations will lower section 404 implementation costs. Ms Murphy, an economist at the SEC, stated:

The incremental benefits and costs of this particular rule are relative to what would happen without the guidance that is being provided to management and the change in the

requirements of the auditor to do interpretation that they are now not going to have to do, and so from that perspective, ***there is uncertainty.***

After carefully reading the transcript of the SEC webcasts, we are unable to see that any serious analysis has been done to date to ascertain specifically how the new SEC/PCAOB guidance will afford significant cost relief to non-accelerated filers. We are disappointed that the SEC does not appear to have attempted to systematically identify and enumerate where cost savings are expected to flow from their new guidance given that the cost burden imposed by the PCAOB Auditing Standard No. 2 has been the number one complaint with SOX 404 rules to date. This is even more disappointing given the magnitude of error in the original SEC section 404 cost burden estimates – a number originally estimated to be around $91,000 per company. The reality has been that more than a few large accelerated filers incurred costs that exceeded $50 million dollars in the initial implementation round and some estimates place the average cost of accelerated filers at more than $4 million. We believe that the SEC should make a concerted effort to estimate what the compliance cost for a typical non-accelerated filer should be both in terms of section 404(a) and 404(b) under the new rules contrasted to the expected costs that would have been sustained under the prior rules driven largely by Auditing Standard No. 2. This has not been done.

We support a call for additional implementation delay, and believe that delaying the implementation of section 404 should be facilitated by U.S. legislators whereby they intervene and amend the Sarbanes-Oxley Act to guide the SEC and PCAOB down a more technically sound implementation path.

The SEC and PCAOB have both indicated that the revised section 404 guidance released in May represents their best effort to correct the severe problems that have accompanied the SOX regulatory regime to date. During the PCAOB webcast on May 24, 2007 Bill Gradison, in the final closing remark prior to the vote to accept AS No.5, stated:

Let's face it, this is our last chance to get the internal control standards right. I believe we have. Others will judge.

With respect, based on our technical analysis, we do not believe the SEC and PCAOB have succeeded in their latest efforts to make the internal controls assessment standards "right".

It is important to note that the majority of the SEC and PCAOB staff that worked on the May 2007 guidance are the same personnel that created and endorsed the original internal control assessment requirements - requirements that resulted in the largest regulatory estimation error in the history of securities regulation. We are very concerned the SEC and PCAOB lack personnel with the necessary skills and experience in the area of globally-accepted risk-based assessment methodologies. The methods proposed to date largely date to the methods taught and used in the late 1970s. Lynn Turner, former SEC Chief Accountant, in February 2007 at the PCAOB Standing Advisory Group stated:

The current interpretation of risk-based auditing is one that is written by auditors for auditors. .... ***The current interpretation in the SOX regulations of risk-based is pretty much the same thing we have had for the last two decades.***

The absence of genuine risk assessment skills is graphically illustrated in the December 2006 draft SEC guidance to management on how to identify the significant risks. On page 23 that guidance states: *Management uses its knowledge and understanding of the business, its organization, operations and processes to consider the sources and potential likelihood of misstatements in the financial reporting elements and identifies those that could result in a material misstatement to the financial statements.*

Risk professionals have learned that utilizing only an experiential approach to identifying and assessing risks is a recipe for disaster. Contemporary risk assessment methods supplement the experience and knowledge of staff with information on risks drawn from other relevant organizations, use a range of techniques to produce a universe of relevant risks, and place huge emphasis on rigorous analysis of system failures to continuously update and improve an organizations understanding of risk. The IMA Statement on Management Accounting issued in January 2007 titled *Enterprise Risk Management Frameworks, Elements and Integration* provides an overview of innovations in the field.

To date, the SEC and PCAOB have, in the spite of extensive feedback from a range of commentators citing deficiencies in the December 2006 drafts, elected to largely stay the course they charted in December. Given their resistance to make fundamental changes to the December exposure drafts, the only viable option that we see at this point is for U.S. law makers to redirect the SOX regulatory regime down a path that will be cost effective and practical for smaller public companies. This is unfortunate as we have always stated unequivocally that we support the intent and wording of the Sarbanes-Oxley Act as enacted by our elected representatives. It is often stated that "THE DEVIL IS IN THE DETAILS". In our opinion, the devil is still in the May 2007 SOX 404 regulatory guidance and needs to be exorcized.

On the next page we list the major areas of deficiency in the current regulatory guidance that require immediate legislative intervention:

Major Deficiencies in Section 404 Regulations for Smaller Public Companies

1. **COST** – We believe that the May SEC/PCAOB guidance will still perpetuate unnecessary costs. Primary cost drivers are: the current regulations are still not truly risk-based, resulting in spending on assessment and testing that is not proportionate to the real risk; inadequate guidance regarding how to direct resources proportionate to the level of current and potential risk; and continuation of excessive focus on process level control testing. Cost levels will continue to be materially impacted by the SEC/PCAOB decision to have auditors form subjective independent decisions on control effectiveness in a world where they face severe litigation liability for wrong opinions. We continue to assert that costs would be lower if auditors were only required to opine on the reasonableness of the assessment *process* management uses to provide section 404(a) representations.

2. **CURRENT CONTROL EFFECTIVENESS PREDICTION ERROR RATE** – The current control assessment methods mandated by Auditing Standard No. 2, and largely perpetuated in the May 2007 guidance, are producing inordinately high prediction error rates. Simply stated, the control assessment methods are seriously unreliable and thousands of control representations by management and auditors are being proven to be materially wrong. Management and auditors are concluding under the rules currently in force that controls are "effective" beyond a remote likelihood. Subsequent events are then proving these "control effectiveness predictions" to be wrong in an unacceptably high number of cases. The frequency with which auditors are still finding material errors in draft financial statements after controls are assessed as effective, resulting in "back-door" material weakness disclosures, continues to be very high. The frequency of restatements of prior years where both management and auditors concluded controls were effective is alarming. A February 2007 report from Audit Analytics reported that the frequency of restatements among Accelerated Filers was 13.3% in 2006; or stated another way, more than one in eight financial statements that were certified as reliable by both management and auditors were subsequently proven to be materially wrong. These companies will have spent many millions of dollars complying with the current section 302 and 404 reporting requirements. Use of these severely flawed methods has so far been restricted to the much smaller accelerated filer registrant populations. **Mandating the use of seriously flawed assessment methods to the approximate 12,000 non-accelerated filers is not advisable.** We believe that additional rigorous research to determine the cause of the current control effectiveness prediction error rates is desperately needed.

3. **RELATIONSHIP WITH EXTERNAL AUDITORS** – Smaller public companies often lack the quantity and depth of resources necessary to interpret accounting rules that are increasingly complex and a primary cause of

restatements. Although little has been said on the subject, the reality has been that external auditors often interpret accounting rules, direct the booking of accounting entries in complex areas including mergers and acquisitions, hedge accounting, deferred tax and other complex areas. In scores of smaller public companies, external auditors have played key roles preparing the financial statements and accompanying notes. Under the current SOX rules, requiring the auditor to report on management control system will, by definition, require the auditors to opine on the reliability of management using the external auditor as a control. Forbidding smaller public companies from using their external auditor to provide direct assistance in these areas will require that management brief two sets of external professionals (one being their external auditors and the other being accounting experts/consultants) on these issues and bear the related incremental costs.

4. **UNFAIR PLAYING FIELD** – To date, no other country in the world has accepted the cost/benefit value of a subjective auditor opinion on control effectiveness (section 404(b)) Three countries, the UK, Canada and Japan, have all directly rejected the merits of this approach after rigorous study. We believe that a significant number of companies considering raising funds in the capital markets will find alternatives to U.S. capital markets, particularly those in the UK and Canada, due to the significantly less complex control governance rules and lower compliance costs.

5. **QUALITY BAR SET TOO HIGH** – The current and proposed regulations require that management produce draft financial statements that are free of any material errors. The existence of even one material error detected by the company's auditors requires, in all but a few instances, a representation by the company's CEO and CFO that the company has an ineffective control system. Our field research indicates that in a very high percentage of smaller public companies, their auditors have routinely found errors material enough in size that adjustments must be made before the auditors provide their certification. A zero material error bar in draft financial statements produced by smaller public companies, while a laudable goal, will put U.S. listed companies at a disadvantage relative to small cap companies in other countries.

6. **LITIGATION IMPACT ON MANAGEMENT AND AUDITORS** – The current and proposed SOX regulations significantly increase the legal liability of both auditors and senior management. Both are being asked to certify that the current controls will allow a material error only in very limited circumstances. History is already proving control effectiveness predictions being made under the current regulations to have a very high error rate. This has already started a new category of litigation focused on negligence in section 404 representations. Adding an additional 12,000 smaller public companies and their auditors in to this pool of litigation targets will not, over the longer term, serve the best interests of society except in extreme cases involving fraud.